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EROSION OF THE INDIVIDUAL INCOME TAX

JOSEPH A. PECHMAN *

THE individual income tax is an important revenue source in most advanced industrialized countries, but nowhere else is it as important as in the United States. In recent years, more than 45 per cent of federal receipts have been derived from individual income taxation. Our heavy reliance on, and the public's approval of, the individual income tax is attributable to the fact that it is particularly suitable for raising revenues in a democratic country where the distribution of incomes from productive activity and, therefore, of ability to pay, is unequal. Although theoreticians still debate whether the ability-to-pay concept is meaningful, it is clear that the public believes there is a significant relationship between income and relative taxpaying ability.

Recognition of the large revenue potentialities of the individual income tax is only a recent development. In 1939, the total yield of the tax at the federal level was less than $1 billion; last year, it produced an estimated $32.5 billion. This growth is explained by the very substantial rise in personal incomes, increases in tax rates, and reductions in the personal exemptions. The lower personal exemptions have transformed the income tax from one which affected only the middle and upper income groups to a mass levy falling on the majority of income recipients.

Although the transformation of this tax during the past 15 years from a minor to a major source of revenue is a solid achievement, its structure is far from ideal and much remains to be done to improve it. Rates are close to peak wartime levels and exemptions are close to their historic lows. With personal incomes in excess of $300 billion per year, must the rates and exemptions be pushed to these extremes? Have the limits of individual income taxation been reached? Will it be necessary to resort to other less desirable sources of revenue if another emergency requires large, additional federal outlays? Or, alternatively, is it not possible to reduce

* The author is a member of the staff of the Committee for Economic Development. Samuel M. Cohn, Richard Goode, Walter W. Heller, William F. Hellmuth, Bert G. Hickman, Stanley S. Surrey, and Norman B. Ture read an early draft of this paper, and I am grateful to them for their helpful suggestions and criticisms. The views expressed herein are personal and do not necessarily reflect those of the CED or of any of the individuals mentioned.

A preliminary summary of the results of this study was presented at the Forty-Eighth Annual Conference on Taxation of the National Tax Association in November, 1955 (see the *Proceedings*, "The Individual Income Tax Base," pp. 304-315).

the present high rates and still retain the individual income tax yield at approximately its present level?

To answer these questions, the entire income tax structure must be reviewed critically. The basic structure has remained unchanged for over a decade, and few people have questioned it publicly. Traditional exclusions and deductions are regarded as inviolable, and much of the effort that goes into tax revision is concerned with broadening rather than narrowing concessions made to particular taxpayer groups. In some cases, the number of taxpayers involved is small; but, in numerous instances, the number runs into millions. The result is that large chunks are removed from the tax base, and increased revenues are obtained when needed by increasing tax rates.

Continued reliance on rate increases to raise the necessary revenues is undesirable from three standpoints. First, the high rates may impair work and investment incentives and, in the long run, may impede economic growth. Second, taxpayers are encouraged to seek new methods to avoid the impact of these rates; management decisions are thus conditioned—and often distorted—by tax considerations. Third, pressure groups develop to obtain for their members new legislative concessions, either on the ground that their tax burdens are too heavy or that similarly situated groups are already enjoying special treatment. It is, of course, impossible to redress inequalities in tax burdens in this way. However fair or reasonable a given concession may appear to be, other claimants for similar relief immediately appear and sooner or later some are successful in obtaining new concessions. This repetitive and costly cycle of erosion has created what appears to be a haphazard tax structure which is hard to defend either on equity or economic grounds.[1]

The practical problems of reconstructing the tax base with this experience behind us are indeed overwhelming. Not the least of the problems is that few people realize how much revenue is lost through the leakages in the tax base. The statistical analysis described in this paper was undertaken to fill this gap. It provides an estimate of the approximate amount of income that would be added to the tax base if all special provisions in the Code—however reasonable they may appear to be—were eliminated. Once having obtained the potential addition to the tax base, it is a simple matter to calculate the size of the rate reduction that could be financed if the entire revenue gain were used to reduce rates. Whether the rates would be reduced by the same percentage or by the same number of percentage points in each bracket, or by any other method, is not a matter of concern for the present discussion.

It should be noted that, in presenting this hypothetical exercise, I do not wish to imply that my judgment of tax

[1] This point has been made by many people on numerous occasions and with increasing frequency in recent years. See, for example, Walter W. Heller, "Limitations of the Federal Individual Income Tax," *Journal of Finance*, May, 1952, pp. 185-202; the contributions by Walter J. Blum, William L. Cary, Thomas C. Atkeson, Harold Groves, and Randolph E. Paul in *Federal Tax Policy for Economic Growth and Stability*, Papers Submitted by Panelists Appearing Before the Subcommittee on Tax Policy of the Joint Committee on the Economic Report, 84th Congress, 1st Session, November 9, 1955; Stanley S. Surrey, "Do Income Tax Exemptions Make Sense," *Colliers*, March 30, 1956, pp. 26-29; and Norman B. Ture, "The Costs of Income Tax Mitigation," *Proceedings of the Forty-Ninth Annual Conference on Taxation Sponsored by the National Tax Association*, 1956 (in press).

equity is superior to that of the average taxpayer. In a democratic society, exclusions and deductions need not appeal to the tax expert, so long as a majority of the voters approves them. The technician's role is to explain the revenue and distributional consequences of the special provisions. If the electorate still considers them desirable on balance, there can be no further argument. However, if the choice between preferential provisions and high rates vs. a comprehensive base and low rates were fairly presented, the average taxpayer might well be more receptive to a thoroughgoing tax revision than the policy-maker or technician might suppose.[2]

As background for the subsequent discussion, Section I describes briefly in quantitative terms the structure of the tax as it stands today. This will provide a basis for judging the relative importance of the various "eroding" features of the income tax. Sections II, III, IV and V are devoted to a detailed discussion of the leakages resulting from the generous deductions, exclusions and credits, special additional exemptions, and preferential rates. For most of the provisions, estimates are given of the approximate magnitudes of the leakages, but in a few instances even a rough guess is not possible. Section VI discusses the leakages due to noncompliance and inadequate enforcement, and suggests that additional revenues can be realized by the extension of the withholding principle to dividends and interest. In the final section, the tax base and tax revenue are calculated on the assumption that all preferential provisions would be eliminated.[3]

The conclusion that can be drawn from these calculations is that the leakages from the tax base are very large, and that we could afford very substantial rate reductions if they were removed. Conservatively, it is estimated that the tax base at 1956 income levels could be raised from $136 billion to $179 billion, an increase of $43 billion or about a third. If the revenue gained from the removal of all the leakages were applied to rate reduction, it would be possible to cut the rates by at least 25 per cent. If, in addition, the tax benefits (but not the principle) of income splitting were eliminated, the rates could be cut by a third. Expressed somewhat differently, it would be possible to cut the top bracket rate from 91 per cent to 61 per cent, and to make equivalent reductions in all other rates, by eliminating all of the preferential provisions in the Internal Revenue Code.

These calculations provide an approximate limit to the rate reductions that would be feasible by a thorough revision of the individual income tax. To an important degree, it is a matter of personal judgment how far the revision should go.

I. *Structure of the Individual Income Tax*

The latest available income tax statistics are for the year 1953, when personal income was more than 10 per cent lower than in 1956. Although it is difficult to project the data several years ahead, the income tax structure will be

[2] Much of the public discussion of the issues in tax revision has been concerned with "loopholes," a term which was originally applied to *unforeseen* avenues of tax avoidance used by taxpayers and their tax attorneys to reduce, or avoid, their share of the tax burden. More recently, it has been used rather loosely to describe many provisions which were *intended* to favor particular groups. In view of the emotional content of the term, I shall avoid its use entirely.

[3] The sources and methods used are described in a separate appendix, which is available on request.

described in terms of estimated magnitudes for the year 1956. This will lend somewhat more realism to the discussion, but the reader must be forewarned that the figures are only approximate. The derivation of the tax base for the years 1948-53 and estimates for 1954-56 are summarized in Table 1.

of the difference between the two figures is accounted for by social insurance payments, imputed incomes, and nontaxable pay and allowances of the armed forces, which are included in personal income but are not subject to tax.

Given a total adjusted gross income of $290 billion, individuals (taxable and nontaxable) will probably report $263.5 billion on their 1956 returns. How much of the difference is accounted for by errors of reporting is unknown, but the amount is significant and we will have more to say about it at a later point. At this stage, it is sufficient to note that taxpayers voluntarily report a very large proportion of the tax they should be reporting—probably in excess

TABLE 1

DERIVATION OF THE INDIVIDUAL INCOME TAX BASE, 1948–56

(Billions of dollars)

Adjustments	1948	1949	1950	1951	1952	1953	1954*	1955*	1956*
1. Personal income	208.7	206.8	227.1	255.3	271.8	286.0	287.3	306.1	325.0
2. Deduct: Conceptual differences between personal income and adjusted gross income	24.4	23.1	26.2	29.0	31.7	32.1	34.4	33.4	35.0
3. Equals: Adjusted gross income	184.3	183.7	200.9	226.3	240.1	253.9	252.9	272.7	290.0
4. Deduct: Nonreported adjusted gross income	20.8	23.2	21.7	23.9	24.8	25.2	25.3	25.5	26.5
5. Equals: Adjusted gross income reported on individual returns	163.5	160.6	179.1	202.3	215.3	228.7	227.6	247.2	263.5
6. Deduct: Adjusted gross income of nontaxable individuals filing returns	21.5	22.0	20.6	19.1	18.7	18.2	18.8	17.8	17.2
7. Equals: Adjusted gross income of taxable individuals	142.1	138.6	158.5	183.2	196.6	210.5	208.8	229.4	246.3
8. Deduct: Deductions of taxable individuals	16.5	16.8	19.0	22.4	24.6	26.9	28.1	31.3	34.0
9. Deduct: Exemptions of taxable individuals	50.9	50.1	55.2	61.4	64.5	67.9	68.0	72.9	77.0
10. Equals: Taxable income of individuals	74.7	71.6	84.3	99.4	107.5	115.7	112.7	125.2	135.3
11. Add: Taxable income of fiduciaries	0.5	0.4	0.6	0.6	0.6	0.6	0.6	0.7	0.7
12. Equals: Total taxable income	75.2	72.1	84.9	100.0	108.1	116.3	113.2	125.9	136.0

* Estimates based on incomplete data.

Note: The concept of "taxable income" was introduced by the Internal Revenue Code of 1954; the corresponding concept for prior years was "surtax net income." Figures are rounded and will not necessarily add to totals.

Personal income for the first nine months of 1956 averaged $322.5 billion (seasonally adjusted annual rate). Since incomes were still rising in the fourth quarter when these estimates were made, it was assumed that personal income would total $325 billion for the year as a whole. The adjusted gross income corresponding to this personal income level is estimated at $290 billion. Most

of 90 per cent.[4] This is not a bad record, particularly since a substantial proportion of the dollar value of the tax errors is due to errors which affect tax liabilities without altering adjusted gross income (e.g., overstatement of personal deductions and exemptions, and mathematical errors). Although the record of compliance needs to be improved, it seems clear that the leakages from the tax base do not result primarily from widespread noncompliance or from inadequate enforcement.

The $263.5 billion of adjusted gross income to be reported on all taxable returns in 1956 will include an estimated $17.2 billion on returns of nontaxable individuals.[5] Deducting the income of nontaxables filing returns, we arrive at an estimate of $246.3 billion for the adjusted gross income of persons subject to tax.

The derivation of taxable income from the adjusted gross income to be reported on taxable returns is a straightforward application of the steps in the calculation on page 2 of the individual income tax form 1040. Personal deductions and personal exemptions are subtracted and the small amount of income of taxable fiduciaries subject to tax is added. As shown in Table 1, it is estimated that taxable income (i.e., the individual income tax base) amounted to $136 billion in 1956. At this level of taxable income, the yield of the individual income tax was probably about $32.5 billion.[6]

The tremendous growth of the individual income tax base since 1939 in both absolute and relative terms is shown in Table 2, which compares taxable income in each year with personal income. In 1939, when personal income was $72.9 billion, taxable income was only $7.5 billion, or about 10 per cent. In 1956, taxable income was almost 42 per cent of personal income. The tax-

TABLE 2

RELATIONSHIP BETWEEN PERSONAL INCOME AND TAXABLE INCOME, 1939–56

(Dollar amounts in billions)

Year	Personal Income	Taxable Income: Amount	Taxable Income: Per Cent of Personal Income
1939	$ 72.9	$ 7.5	10.3%
1940	78.7	11.0	14.0
1941	96.3	22.9	23.8
1942	123.5	36.4	29.4
1943	151.4	50.5	33.4
1944	165.7	55.7	33.6
1945	171.2	57.6	33.6
1946	178.0	65.8	37.0
1947	190.5	75.9	39.8
1948	208.7	75.2	36.0
1949	206.8	72.1	34.9
1950	227.1	84.9	37.4
1951	255.3	100.0	39.2
1952	271.8	108.1	39.8
1953	286.0	116.3	40.7
1954	287.3	113.2 *	39.4
1955	306.1	125.9 *	41.1
1956	325.0 *	136.0 *	41.8

* Estimates based on incomplete data.

[4] See Marius Farioletti, "Some Results of the First Year's Audit Control Program of the Bureau of Internal Revenue," *National Tax Journal*, March, 1952, pp. 65-78. For a brief discussion of the results of this study, see Section VI below.

[5] Many of these persons file returns because their incomes exceed the very low filing requirements ($600 for taxpayers below 65 years of age, and $1,200 for those 65 and over). However, most nontaxable returns are filed by individuals claiming refunds for tax which was withheld from their wages. This overwithholding occurs because withholding is geared to the current paycheck and does not take into account variations in income, deductions, or exemptions during the remainder of the year.

[6] This figure differs from individual income tax collections as reported in the Budget of the United States in three respects: (1) it is on a calendar year rather than a fiscal year basis, (2) it is net *after* the deduction of year-end refunds for overpayment of tax, and (3) it does not include deficiences assessed for prior year taxes.

able income percentage increased almost continuously throughout the period, with interruptions only when nontaxable military pay was large (1945), when exemptions were increased (1948) and when nontaxable transfer payments increased during recession years (1949 and 1954).

This growth in the tax base is, of course, familiar to most of us. However, little attention has been paid to the portion of personal income still outside the tax base, which totalled about $189 billion in 1956. Personal exemptions and the income of nontaxable individuals filing returns (which is normally less than the personal exemptions to which they are entitled) accounted for $94 billion of this amount; but even if these are excluded, there still remained $95 billion of personal income not subject to tax. The size of this leakage suggests that there is room for broadening the tax base very substantially.

II. *Deductions*

There is no recorded explanation for many of the deductions now allowed under the individual income tax, but most of them have been accepted through long usage. In recent years, the scope of the deductions has been enlarged considerably, and further liberalization is to be expected if present trends continue.

In theory, the only deductions that are absolutely essential under a personal net income tax are those which make allowances for the cost of earning income. Some deductions for unusually large but essential personal expenditures may be necessary to prevent hardship if the exemptions are very low, but they should be kept to a minimum.

These general criteria have been violated to a substantial degree by the galaxy of personal deductions now written into the Code. In fact, the leakage from the generous deductions exceeds the leakage from any other single element of the individual income tax structure.

A. *Purposes of deductions.* There are four major groups of deductions under present law. The first group is intended to supplement the low personal exemptions for large, unusual, and necessary personal expenditures. Deductions for extraordinary medical expenses are the best examples of this group. They are often involuntary, unpredictable, and may exhaust a large proportion of the taxpayer's total income. When a serious illness strikes a member of the family, its ability to pay taxes is clearly lower than that of another equal-income family whose members have been healthy throughout the year. Other deductions which seem to be justified on this basis are the deductions for noninsured losses due to theft, fire, storms, accidents, or other casualties. Deductions for alimony payments may also be classified in this group even though they are not unpredictable.

The second group of deductions in effect provides subsidies to particular taxpayers. Thus, deductions for taxes paid on owner-occupied residences and for interest on home mortgages were presumably intended to subsidize home owners. This is part of the American tradition, dating back to our early history, of encouraging home ownership. Together with the exclusion from taxable income of the rental value of owned homes, the deductions for property taxes and interest on home mortgages make a substantial concession to this tradition.

In addition to the direct benefit from

the deductions for taxes and interest, home owners also derive an indirect benefit by being able to utilize other itemized deductions. Other taxpayers, particularly those in the lower and middle income brackets who rent their living quarters, can rarely accumulate deductions aggregating more than the standard deduction. The result is that home owners are the primary beneficiaries of the remaining deductions. Moreover, when a new deduction is added to the Code, the full benefit ordinarily goes to home owners who already itemize. Other taxpayers must sacrifice a portion of their standard deduction before they actually receive some value from the new deduction.

Another deduction of the subsidy type is the deduction for contributions to charitable, religious, scientific, educational, and other nonprofit organizations. The purpose of this deduction is to encourage taxpayers to maximize their contributions. It may be argued that private philanthropy should not be encouraged at the expense of the Federal Treasury, since it involves the diversion of tax funds by individuals to organizations of their own choice. However, few people have expressed this view publicly because the activities of these organizations are generally considered socially desirable. Moreover, with rates rising to 91 per cent in the highest bracket, this objection is academic; contributions by the wealthiest taxpayers might be reduced sharply if the deduction were eliminated under the present rate structure.

The deductions for interest on personal loans are also in the nature of subsidies, but they are more difficult to rationalize. The fact that an interest deduction has been allowed since the modern income tax was enacted in 1913 may be a reflection of the public's antipathy toward the usurious practices of money lenders in earlier days. An alternative explanation is that it is difficult to draw the line between the purposes of personal loans and business loans of single proprietors and partners.

The third group of deductions is for income and sales taxes paid to states and local governments. The deduction for income taxes is necessary to prevent the combined federal, state, and local income taxes from becoming confiscatory. For example, if the income of a taxpayer were subject to the highest state rate of 11 per cent and also to the 91 per cent rate for federal tax purposes, the combined marginal rates would be 102 per cent. By allowing taxpayers to deduct the state tax on their federal returns, the combined rate is reduced to 92 per cent. If the state also permits a deduction for federal taxes, the combined rate is only slightly above the federal rate, 91.1 per cent.

The deduction for income taxes is a practical necessity with present high rates, but the same justification does not hold for the deductions allowed for state and local sales and excise taxes. These deductions defeat the purposes of consumption taxes levied to obtain payments from taxpayers for benefits received, reduce the progressivity of selective excises on luxury goods, and increase the regressivity of general sales taxes.[7] They are also objectionable on the practical ground that it is virtually impossible to check the estimates taxpayers make to arrive at the amounts they claim. Deductions for federal excise taxes, which were allowed at one time, were eliminated under the Revenue Act of 1943. Deductions for non-

[7] See William Vickrey, *Agenda for Progressive Taxation*, Ronald Press (New York, 1947), p. 94.

federal consumption taxes were probably continued to avoid the opposition of state and local governments.

The fourth group of deductions contains the only deductions which are theoretically necessary, namely, those which make allowances for expenses of earning income. These deductions are required to correct the deficiencies of the adjusted gross income concept—a statutory concept which is intended to approximate net income after allowing for expenses incurred in earning such income. For administrative reasons, expenses incurred in earning nonbusiness incomes (i.e., wages and salaries, interest, and dividends) are generally not allowed as deductions in arriving at adjusted gross income. This deficiency is corrected by permitting taxpayers to deduct such expenses in arriving at taxable income.

Some examples of these deductions are fees for investment counselors, rentals of safety deposit boxes used to store income-producing securities, custodian fees, work clothing, and union dues. However, no one of these is as large dollarwise as the deduction for child care which was enacted for the first time in 1954. This deduction permits all employed single persons and married couples having incomes of less than $4,500 with both husband and wife employed to deduct up to $600 for the cost of child care while they are at work. The rationale of this deduction, as stated by the two Congressional tax-

TABLE 3

RATIO OF DEDUCTIONS TO ADJUSTED GROSS INCOME, ITEMIZED RETURNS, 1953

Adjusted Gross Income Classes	Per Cent of Adjusted Gross Income						
	All Deductions	Contributions	Interest	Taxes	Losses from Fire, etc.	Medical & Dental Expenses	Miscellaneous
Nontaxable returns							
Under $1,000	59.8	8.5	4.9	13.0	*	21.8	*
$1,000– 3,000	37.4	5.7	3.7	6.5	1.4	14.8	5.3
3,000 and over	37.9	4.8	5.9	5.1	2.9	8.6	10.6
Total, nontaxable returns	38.7	5.3	5.0	6.0	2.3	11.8	8.3
Taxable returns							
$ 600–$ 1,000	22.2	5.4	1.9	4.5	0.5	7.1	2.9
1,000– 3,000	22.7	5.7	2.5	4.4	0.6	6.7	2.8
3,000– 5,000	19.7	4.5	3.7	4.3	0.5	4.0	2.9
5,000– 10,000	18.4	3.9	3.9	4.3	0.5	2.3	3.5
10,000– 15,000	17.7	3.8	3.0	4.4	0.3	1.8	4.3
15,000– 20,000	15.5	3.6	2.3	4.3	0.2	1.3	3.7
20,000– 50,000	13.1	3.4	1.7	4.2	0.2	0.8	2.8
50,000– 100,000	12.9	4.0	1.5	4.0	0.2	0.4	2.7
100,000 and over	16.6	7.1	1.8	4.1	0.2	0.2	3.2
Total, taxable returns	17.9	4.2	3.2	4.3	0.4	2.5	3.3
Total, all returns	18.6	4.2	3.3	4.3	0.5	2.9	3.4

* Sampling variability in these cells was too large to warrant publication of figures on which these percentages are based.

Note: Returns with no adjusted gross income are excluded. Figures are rounded and will not necessarily add to totals.

Source: *Statistics of Income for 1953*, Part 1, Preliminary Report, Table 2, pp. 14–15.

writing committees, is that such expenditures must be incurred by taxpayers to earn a livelihood and they are, therefore, comparable to an ordinary business expense.

The relative importance of the itemized personal deductions at different income levels in 1953—the latest year for which detailed statistics from tax returns are available—is shown in Table 3. This table understates the deductions now claimed at all income levels, because the list of allowable deductions was enlarged by the Internal Revenue Code of 1954. Nonetheless, it gives a good picture of the types of deductions reported at the various income levels.

The largest deductions at practically all income levels are the deductions for contributions and taxes, but medical expenses are the most important in the lowest income brackets. This results from the fact that medical expenditures amounting to less than 5 per cent of adjusted gross income were regarded as "ordinary" for most taxpayers in 1953.[8] Since this 5 per cent floor (3 per cent under present law) automatically increases the dollar amount of "ordinary" medical expenses as incomes rise, deductible medical expenditures drop off sharply at the upper end of the income scale. The category of deductions labeled "miscellaneous" in Table 3, which includes the allowances for expenses of earning income and alimony payments, accounts for little more than one-sixth of all deductions listed by taxpayers.

Because most people with income below $10,000 have the alternative of taking the 10 per cent standard deduction, those who itemize at these levels subtract more than 10 per cent of their adjusted gross income. As incomes go beyond $10,000, where the maximum standard deduction of $1,000 becomes effective for married people, the itemized deductions account for a much smaller percentage. However, there is remarkably little variation in the average ratio of standard *and* itemized deductions to total income among the various income groups. Thus, in 1953, the standard and itemized deductions combined amounted to 12.6 per cent of adjusted gross income in the income groups below $5,000, 13.1 per cent between $5,000 and $10,000, 12.2 per cent between $10,000 and $30,000, and 12.6 per cent above $30,000.

Estimates of the dollar magnitudes of the deductions claimed on taxable returns in 1956 are given in Table 4. The total was probably in the neighborhood of $34 billion. Of this amount, $13 billion is the value of the standard deduction, which is used by 75 per cent of the persons who file; the remaining $21 billion is the value of the deductions of those who prefer to itemize rather than to take the standard deduction. Actually, taxpayers who itemized would have been permitted to deduct approxi-

TABLE 4

ESTIMATED AMOUNT OF DEDUCTIONS CLAIMED ON TAXABLE RETURNS, 1956
(Billions of dollars)

Deduction		Amount
Standard deduction		13.0
Itemized deductions:		
Contributions	4.4	
Interest	4.0	
Taxes	5.1	
Losses from fire, storm, etc.	0.4	
Medical and dental expenses	3.3	
Miscellaneous	3.8	21.0
Total deductions		34.0

[8] Taxpayers over 65 years of age have been allowed to deduct all medical expenses since 1951.

mately $10 billion if they elected to use the standard deduction, so that the privilege of itemizing permitted them to deduct $11 billion more than the standard deduction would have provided.

B. *Possible revisions of the personal deductions.* Since we are abstracting from practical political problems, revision of the present structure might begin by limiting the personal deductions to those which are absolutely essential for a net income tax. Table 4 indicates that the largest deductions are of the subsidy type, i.e., charitable contributions, interest, and taxes. Together, these deductions accounted for an estimated $13.5 billion on taxable returns in 1956, almost two-thirds of all itemized deductions. This includes the deduction for income taxes which must now be allowed to avoid confiscatory federal-state rates and, therefore, is not strictly a subsidy-type deduction.

The major argument against the elimination of deductibility for state income taxes is that it might lead to competition among the states to reduce their top rates and this might, in turn, discourage the use of these taxes at the state level. In practice, however, about two-thirds of the states now permit taxpayers to deduct the federal income tax in computing their state taxes. The result is that state taxes add very little to the net burden of high income taxpayers. If federal tax rates were cut by a third, the states might be encouraged to eliminate the deductibility features of their own income taxes and thus to raise more revenue from the higher income classes than they do at the present time. Deductibility would be helpful at the federal level, as a device to minimize interstate income tax differentials. This argues for retention of the deduction for income taxes, but not for other taxes levied by the states and local governments.

Elimination of the deduction for contributions would probably have little effect on charitable giving by the lower and middle income classes, since the income tax advantage is relatively small at these levels. Even at the highest levels, philanthropy would probably be affected very little, because aggregate tax burdens would remain unchanged. However, if an income tax deduction is deemed necessary to encourage philanthropy by wealthy taxpayers, it would be better to design the deduction as an incentive device for these groups alone rather than to waste revenues, as we do today, by granting the deduction to everyone. For example, the deduction might be allowed for the amount of contributions in excess of, say, $1,000 per year, with the total deduction limited to 20 per cent or 30 per cent of adjusted gross income.

If deductions were retained for state and local income taxes and for contributions in excess of $1,000, the $13.5 billion now deducted on taxable returns for contributions, interest and taxes would be reduced to $1.1 billion. The remaining $12.4 billion would be added to the tax base.

The medical expense deduction is now allowed in full for taxpayers 65 years of age and over, and to the extent that it exceeds 3 per cent of adjusted gross income for those under 65. For those over 65, the full allowance is clearly too large under the criterion that the deduction should be limited to *extraordinary* expenses. As for those under 65, the 3 per cent figure is about equal to the median expenditure of families with incomes below $10,000.[9] However, the

[9] *National Family Survey of Medical Costs and Voluntary Health Insurance*, Health Information Center (New York, 1954), Table 14, p. 45.

median is only an arbitrary dividing line between " usual " and " extraordinary "; the 75 per cent or 90 per cent levels would be equally logical if the resulting percentage of income is not inordinately high. According to a recent survey, about 60 per cent of the families incur medical expenses under 5 per cent of their incomes.[10] To limit the casualty losses is small, a tightening of the definition will not add a significant amount of income to the tax base.

The only remaining category of itemized deductions is the miscellaneous group. As already indicated, this category consists mainly of deductions which are intended to refine adjusted gross income to a net basis. There may be some deductions even in this group revenue loss of the deduction without violating its basic rationale, the lower limit might be restored to 5 per cent for all taxpayers. This would probably reduce the medical deduction by $500 million on taxable returns with itemized deductions.

Losses from fire and theft or other casualties are small in aggregate amount —about $400 million on taxable returns. A portion of these deductions is attributable to the liberal interpretation of casualty loss, which includes costs of repairing dented automobile fenders and other minor damages around the home. At the very least, such deductions could be eliminated because they are not of the unusual type envisaged when deductions for casualty losses were originally allowed.[11] Since the whole category of that might be eliminated, but it may be assumed that the amounts are small.

We may conclude that itemized deductions amounting to $12.9 billion could be eliminated if they were trimmed to the most essential items. But this is not all. If the list of itemized deductions were curtailed, the standard deduction would be much too generous. Originally, the standard deduction was adopted for purposes of simplification. It was recognized that most personal deductions are relatively small and few taxpayers keep adequate records to support them. Proper auditing of personal deductions in 60 million returns would be a virtual impossibility. Although some have argued that the adoption of the standard deduction involved some loss in equity, the improvement of compliance and administration was undoubtedly worth the cost.[12] There may actually have been a net gain even on equity grounds, because most personal deductions are not justifiable in principle, and a high standard deduction eliminates a major share of the differential benefits which they bestow on those who can itemize them.

Taxpayers now regard the standard deduction as a matter of right, and few proposals would be more unpopular under present circumstances than a proposal to eliminate or reduce it. However, the elimination of the bulk of the

[10] *Ibid.*, Table 15, p. 46.

[11] It would be preferable to reword the definition of the deduction to exclude such minor losses. However, if this proves to be too difficult, an alternative might be to permit deductions for the same losses that are now included to the extent that they exceed 1 or 2 percent of adjusted gross income.

[12] In the United Kingdom, where a standard deduction has never been adopted, it has been necessary to devise a system whereby the tax assessor divides all taxpayers into about 100 different groups depending upon their deduction and exemption status. Each individual is assigned a group code by the assessor; this code is then used for withholding purposes and for the purpose of computing the individual's final tax liability. This system is much more cumbersome than ours and there is considerable doubt whether the gain in equity is worth the additional burdens imposed on employers and tax assessors.

ERRATUM: Column 1 of Page 11 in the March, 1957 issue of the JOURNAL should read as follows:

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deductions and the reduction of the marginal rates could be made the occasion for eliminating the standard deduction.[13] Taxpayers could be permitted to itemize the few remaining deductions without much loss of simplification. This would add another $10.1 billion to the tax base over and above the $12.9 billion gained by the elimination of the itemized deductions enumerated above. In combination, these revisions would reduce deductions reported on taxable returns by $23 billion.

III. *Exclusions and Tax Credits*

Another substantial portion of the leakages from the tax base is accounted for by the exclusions and tax credits which benefit taxpayers throughout the income scale. Exclusions for transfer payments, and wage supplements and the credit for retirement income benefit mainly the lower income groups. Interest on savings invested in life insurance and the rental value of owner-occupied dwellings, which have never been included in taxable income in this country, probably accrue largely to taxpayers in the middle income brackets. And interest on state and municipal bonds, dividends, depletion, and capital gains—all of which receive preferential treatment—are concentrated at the higher income levels.

The reasons for these exclusions and credits vary. Some are not received in cash and are excluded for practical reasons. In other cases, the exclusion or credit is justified on the ground that the application of the high ordinary rates would produce undesirable economic effects. In still others, the exclusion or credit is an outright subsidy, intended to be of assistance to particular groups of taxpayers. Although there may be good reasons for a few of the exclusions with rates as high as they are today, the justification for most of these would be eliminated if the rates were reduced substantially.

The following discussion summarizes the major categories of exclusions and tax credits and indicates the approximate amounts of income involved. It has not been possible to take into account all of the minor provisions which might be disclosed by a thorough review of the Internal Revenue Code. It would be desirable to remove even the minor items, in order to avoid the charge that a few taxpayers will continue to receive preferential treatment, and to prevent their use as precedents for future erosion of the tax base.

A. *Transfer payments and wage supplements of low-income employees.* Numerous exclusions specifically listed in the Internal Revenue Code or granted by the Regulations are in the nature of transfer payments and wage supplements. Some of these payments arise out of social insurance and relief programs enacted during the 1930's to alleviate personal hardship from unemployment, sickness, and old age. Since the recipients were in general unable to pay taxes and were, in any case, not subject to tax under the relatively high personal exemptions in effect at the time, the exclusion of these payments did not create any substantial inequities.

The conversion of the income tax to a mass tax during the war by the reduction of exemptions, the increases in the average amounts paid, and the gradual expansion of the programs to include individuals who are not necessarily in

[13] If the standard deduction were retained, it would not have to be larger than 2-3 per cent of adjusted gross income. This would be sufficient to avoid the inconvenience of accounting for, and checking, small amounts of itemized deductions.

dire straits, have altered the situation completely. Recipients of such supplements and transfer payments are frequently much better off than their neighbors who cannot exclude any portion of their incomes in computing their tax liabilities. It is in this area particularly where new concessions are introduced periodically to correct inequalities arising from actions taken when the tax benefits were of negligible importance.

The war and postwar emergency conditions have also left a legacy of exclusions. Military personnel and veterans receive numerous benefits which are excluded from the tax base primarily because it seemed unfair to tax those who risked their lives in the national interest. Now, many of these payments are justified on incentive grounds, and are little more than concealed pay increases the values of which depend on the recipient's other incomes. There is no question that an adequate salary scale is necessary to attract qualified personnel into the armed forces, but the use of tax exemption is hardly the appropriate method of accomplishing this objective. Like the exclusions for social insurance benefits, these have also been cited as precedents for concessions that have further eroded the tax base.

The exclusions traceable to depression or wartime conditions include the following: (1) old-age and survivors and railroad retirement insurance benefits; (2) public assistance payments; (3) unemployment compensation; (4) workmen's compensation; (5) military retirement and disability benefits; (6) nontaxable military pay and allowances; (7) mustering-out payments to members of the armed forces; (8) veterans pensions; and (9) readjustment and subsistence allowances to veterans. The retirement income credit should be added to this list, since it was enacted in an attempt to equalize the tax treatment of private pensions and social security benefits. Similarly, the exclusion of payments of less than $100 per week under wage continuation plans during an employee's illness was deemed necessary to equalize the treatment of payments under private and state approved plans. The exclusions in this list probably amounted to roughly $8.5 billion on taxable returns in 1956; and, if these were eliminated, the revenue loss of $140 million from the retirement income credit could also be avoided.

It may be argued that it would be unfair to include transfer payments in adjusted gross income unless they were increased to pay for the additional tax burden imposed on the recipients. This would be a valid objection if the income tax were levied without exemptions. However, the exemptions would prevent the imposition of tax on those who cannot afford to pay by the standards in today's income tax structure. If the exemptions are considered too low, it would be more equitable to discontinue the exclusions for transfer payments and to raise the exemptions for all taxpayers. Under present circumstances, individuals receiving transfer payments often have substantially higher effective exemptions than other taxpayers with equal incomes received entirely from taxable sources.

An adjustment of the Code would be required, however, to prevent double taxation of contributions made by individuals during their working lives to the OASI and railroad retirement programs. This could be done by applying the annuity rule now in the Code, under

which an annuitant or pensioner recovers the value of this investment tax free during the period of his average life expectancy. The compliance problem would be extraordinarily great for most beneficiaries of the social insurance programs, if they were required to make the necessary computations; but the burden can be assumed by the agencies making the payments. Insurance companies now make similar computations for their annuitants, and Government agencies should be expected to do the same. Total benefits paid by the social insurance systems are already large, and they will mount very rapidly during the coming decades as the systems mature and as the population ages. Elimination of the exclusions for social insurance benefits and of the credit for retirement income will, therefore, prevent the very substantial shift in the tax burden to the younger groups, which is inevitable under the present tax system.

B. *Imputed rent of owner-occupied homes.* Elimination of personal deductions for mortgage interest and taxes on owner-occupied residences would not be sufficient to remove the present discrimination against those who rent. The fact that the *net* imputed return on the investment in a home is ignored in computing adjusted gross income would still put the home owner in a much better position taxwise than the renter. This may be illustrated by the following example cited by Vickrey: "*A* may rent his home with the $800 he gets from $20,000 worth of securities, while *D* sells $10,000 of securities and buys a similar home with the proceeds, using the $400 income from the remaining securities to pay taxes and maintenance costs and to set aside against the depreciation of property. With no tax, *A* and *D* are in the same position economically, but under the Federal law not only does *D* have only $400 to report as income as compared with *A's* $800, but from the $400, *D* will be able to deduct that part used to pay property and other taxes on the home." [14]

The compliance and administrative problems of taxing the imputed rental income of owner-occupied homes are undoubtedly difficult; in fact, our failure to tax such income may well be attributable to these difficulties.[15] Yet this exclusion impairs the equity of the income tax to a substantial degree, since home ownership increases with income. Henry Simons, writing in 1938, noted that the tax laws in most countries counted rental income to home owners as taxable income.[16] Apparently, Canada and the United States were the most noteworthy exceptions. In view of the widespread experience in other countries, it would appear that the practical problems are not insurmountable.

Ideally, the best method of calculating imputed net rent would be to estimate the gross rental value of the owner-occupied home on the basis of actual rentals paid on similar properties nearby and to permit the taxpayer to deduct taxes, interests, the cost of repairs and maintenance, and depreciation.[17] This method is similar to that

[14] William Vickrey, *op. cit.*, p. 18. See also the illustration cited by Melvin I. White, "Deductions for Nonbusiness Expenses and an Economic Concept of Net Income," *Federal Tax Policy for Economic Growth and Stability, op. cit.*, p. 359.

[15] Some might also question whether it is constitutional to tax imputed rent, but I am told that most lawyers believe that there would be no constitutional problem.

[16] Henry Simons, *Personal Income Taxation*, University of Chicago Press (Chicago, 1938), p. 112.

[17] This is not inconsistent with the suggestion made in Section II that the deductions for interest on home mortgages and property taxes be eliminated. These deductions are not justified as personal deduc-

(See next page)

used in Great Britain.[18] However, rental values are difficult to determine; in addition, outlays for permanent additions to residences are hard to distinguish from outlays for repairs and maintenance. Two alternative methods suggested by Vickrey would be less exact, but much easier to administer.[19] The first is to impute a modest rate of return to the home owner on the basis of his net equity; the second, is to impute a return on the entire value of the house and to permit the taxpayer to deduct interest on his mortgage.

If a serious effort were made to include net imputed rent in adjusted gross income, these and other methods would need to be studied carefully. The potential addition to the tax base from this source is substantial—probably in the neighborhood of $4 billion.[20]

C. *Consumption of home-produced food and stock-in-trade.* Another noncash income which escapes taxation for practical reasons is the food produced and consumed on farms. The farmer benefits not only from the fact that this type of income is ignored for tax purposes, but he also deducts the expenses incurred in producing it. Valuation of such income would be even more difficult than in the case of imputed rent, because few farmers keep records of their home consumption. The only practical method of reaching this income would be to adopt a presumptive rule under which a given amount per person in the family would be added to the farmer's income. The farmer could be given the alternative of listing the actual amounts of home-produced food consumed, if he kept adequate records. Assuming that the presumptive income would be $75 per person in the family per year, the amount that would be added to taxable income by this revision would be $400 million.

Many small businessmen in the distributive and service industries also have opportunities to withdraw part of the proceeds of the business in noncash form. Such withdrawals are probably large in wholesale and retail establishments, like food, apparel, and appliance stores, where the stock-in-trade is directly useful for home consumption. The owners of service establishments benefit to some extent, since they are able to finance necessary family services tax-free in the ordinary course of their business operations. Because such opportunities exist in a wide variety of wholesale, retail, and service outlets, a fairly long list of presumptive tests would be needed to meet the problem. It will be difficult to arrive at reasonable presumptions, but the individual taxpayer would have an opportunity to substitute actual withdrawals if he kept adequate records. Unfortunately, it is impossible to estimate the amounts of income that might be added to adjusted gross income in this way.

D. *Earnings supplements of high-income taxpayers.* Among the most important examples of tax erosion resulting from the high tax rates imposed during the past 15 years are the nontaxable earnings supplements of high-salaried executives and self-employed

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tions, since gross imputed rent is not now included in adjusted gross income. If gross imputed rent were included, it would be necessary to allow interest and taxes as costs of earning this type of property income.

18 Vickrey, *op. cit.*, pp. 19-20.

19 *Ibid.*, p. 21.

20 This estimate is net *after* the allowances for interest and taxes and other costs of home ownership. It can, therefore, be added to the estimated increase in the tax base resulting from the elimination of the deductions enumerated in Section II, without involving any duplication.

businessmen and professionals. Deferred compensation and stock options have replaced cash salary increases as a method of rewarding top corporate executives, and tax-free expense accounts are used to pay not only legitimate business expenses but also large personal expenditures of the individual and his family. Individuals have at their disposal company cars, planes, and boats, for personal use; charge off as entertainment expenses the cost of theaters, nightclubs, restaurants, baseball games, boxing matches, and other sports events; take advantage of company facilities during vacations; and finance expensive pleasure trips abroad for themselves and their families.[21]

Of these various practices, the problems posed by deferred compensation and stock options can be dealt with directly by statutory revision. Such incomes could be counted as taxable income to the employee during the year they are earned, with payment of tax deferred until the income is actually realized. It may be necessary to wait until the employee's right to the deferred payments becomes nonforfeitable before the tax computation is actually made,[22] but the principle of taxing these payments in the year they are earned can still be applied. The popularity of such payments would undoubtedly decline as a result of the reduction in the top marginal rates that would be made possible by the removal of these and other leakages in the tax base. Perhaps more important, the incentive effects of cash salary increases would be restored and the mobility of corporate executives would be increased.

The problem of taxing the elements of personal consumption in expense accounts and in the use of services and facilities provided by corporations and businesses to their employees and owners is much more difficult. In part, it can be met by administrative action, although the Secretary of the Treasury would probably be loathe to move too far in this direction without Congressional authorization. It would be virtually impossible to write into the Code all of the detailed rules that would be necessary to cover every situation. A general statement of the intent of Congress might be sufficient to permit the Secretary to tighten the regulations.

These changes in the treatment of earnings supplements of high-income taxpayers could add substantial amounts to taxable income, but there is at the present time no basis for making even an approximate estimate of the magnitudes involved.

E. *Property incomes.* The amounts of the exclusions and credits granted to recipients of property income are in some cases smaller in total magnitude than those previously discussed, because property incomes are a small proportion of total income. However, the tax benefits are sizable in the higher income classes where property incomes are concentrated. Complete exemption is accorded to the interest on savings invested in life insurance and to interest on state and local government bonds; long-term capital gains are taxed at rates varying between a half and a

[21] For an interesting account of methods used to escape the impact of high marginal rates, see *Business Week*, July 16, 1955, p. 45.

[22] Deferred compensation does not actually belong to the employee until he meets certain requirements, e.g., length of service and age. In addition, many contracts provide that the employee forfeits his rights to the deferred compensation if he later works for a competitive firm. Since it is not possible to tax income that is forfeitable, it would be necessary to delay the tax reconciliation until it becomes nonforfeitable.

quarter of the ordinary rates if they are realized and are exempt if retained until death; owners of mineral properties are granted liberal depletion allowances and the privilege of immediately writing off expenditures for exploration and development of new properties; and the dividend credit reduces the marginal rate on dividends by four percentage points.

On the basis of the present definition of adjusted gross income, average effective tax rates in the highest income groups have been no greater than 60-65 per cent in recent years.[23] If the effective rate were calculated on the basis of total income (i.e., the income including the items that are now excluded from adjusted gross income), the actual average effective rate in the top income ranges would probably run no higher than 50 per cent or even lower.

Some have argued that the present tax discrimination among different income receipts has not had a detrimental effect on the economy. In fact, it has been stated that "by and large, the tax structure appears to have had only a limited and specialized impact on the basic incentives which motivate the private economy and on the structure of the economy." [24] However, although the economy has prospered in the postwar period with a tax structure which taxes some investment incomes fully and others only partially or not at all, the economic effects are not necessarily of negligible importance. Investment incentives might be better protected, and the allocation of investment funds among alternative opportunities improved, by a structure which accords similar treatment to property income irrespective of its source.

The tax exemption accorded to savings invested by individuals in life insurance results from the fact that interest accumulated on policy reserves is not taxable to the policyholder, while at the same time the insurance proceeds are not taxable to the beneficiaries after the death of the insured. This income could be taxed by including in taxable income the portion of the annual increases in the cash surrender value of life insurance policies that reflects interest earned on past savings. The leakage is large—amounting to at least $1.1 billion in 1956. Since taxpayers are likely to underreport this type of income very substantially—just as they underreport interest receipts that are currently taxable—it would be necessary to withhold the tax at the source in order to avoid wholesale noncompliance. The withholding system to be described in Section VI would be ideally suited for this purpose.

Individuals probably received about $500 million of tax-exempt interest last year, and the amount is likely to increase sharply in future years as the states and municipalities continue to increase their construction programs. A major impediment to the taxation of interest on securities issued by these units of government has been the fear that the increased debt service costs will be too burdensome. This fear may be justified under present high rates, but the problem would be much less serious if the top marginal rates were in the neighborhood of 60 per cent rather than 90 per cent. From an over-all economic standpoint, the removal of

[23] See, for example, *Statistics of Income for 1953*, Part 1, Preliminary Report, Table 1, p. 10.

[24] J. Keith Butters, "Taxation, Incentives, and Financial Capacity," *American Economic Review*, Supplement, May, 1954, p. 505.

the present incentives of high income taxpayers to invest in tax-exempt securities might be well worth the additional costs that would be incurred by state and local taxpayers.

Full taxation of long-term capital gains would raise more serious economic issues. Most taxpayers simply exclude half of their net long-term gains from adjusted gross income and do not benefit from the 25 per cent alternative tax. For them, the marginal rates on long-term gains would probably be very little higher under the schedule of reduced rates than under present law. On the other hand, even if the top marginal rates were cut by a third, the tax might discourage transfers of assets by those who are in the brackets in which the alternative tax applies. This effect could be minimized by (a) taxing unrealized capital gains on assets transferred by gift or death; (b) adopting an averaging system to avoid the "bunching" effect of realizations of large gains accrued over a long period of time, and (c) allowing full carryovers for capital losses which cannot be offset against gains and a reasonable amount of ordinary income. Elimination of the tremendous tax advantage of holding assets for at least six months would also tend to encourage asset transfers.

There is no basis for judging whether this combination of revisions will produce more or less capital mobility than the present capital gains structure. It would, however, halt attempts of taxpayers to convert ordinary incomes into capital gains or to obtain coverage for such income under the capital gains umbrella through legislation. It would also automatically eliminate the preferential treatment now accorded to such diverse types of ordinary incomes as coal royalties, patent royalties, the value of stock options, and profits from the sale of timber, livestock, and unharvested crops.

Since capital gains are highly variable, it is impossible to estimate how much would be added to the tax base in any given year if they were taxed in full. Moreover, there are no data on the amounts of capital gains which are transferred each year by gift or death. For the entire period 1946-52, the excluded portion of realized long-term capital gains reported on taxable returns averaged $2.7 billion per year, and the excluded portion of realized long-term losses averaged $0.5 billion. This period included years in which stock prices were falling (1946), stable (1947-49, and 1952), and rising (1950-51). Accordingly, it is probably not too unrealistic to assume that the average net gain excluded during this period ($2.2 billion) would be added annually to taxable income. It may well be that there would be a tendency for individuals to realize losses and to defer the realization of gains under the new structure, but the effect would be only temporary since there would be a tax reconciliation at gift or death.

The recently adopted $50 exclusion and 4 per cent credit for dividends were intended to mitigate the so-called double taxation of dividend income. The pros and cons of the controversy over these provisions have been discussed at length and will not be repeated here.[25] It is obvious, however,

[25] See, for example, Richard Goode, *The Corporation Income Tax*, Chapter Ten, John Wiley and Sons (New York, 1951); Daniel M. Holland, "The Differential Tax Burden on Stockholders", *Papers and Proceedings of the American Economic Association*, May, 1955, pp. 415-429; Dan Throop Smith,

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that they satisfy no one: those who believe that the tax burden on dividend income is too heavy would argue that the 4 per cent credit is inadequate; those who oppose special treatment for dividends favor immediate repeal of both the exclusion and the credit. Under the circumstances, substantial reductions in the marginal rates would probably be more satisfactory to both sides.[26] Repeal of the exclusion would add about $200 million to taxable income. Repeal of the credit would leave taxable income unchanged, but would add approximately $400 million to the yield of the individual income tax at present rates.

The preferential treatment accorded to income from mineral properties can be removed by eliminating percentage depletion and the privilege of writing off exploration and development expenditures when they are made. It is known that noncorporate owners of oil and gas properties receive substantial tax benefits from these provisions—an amount recently estimated at $700 million.[27] It would, of course, be unwise to alter these provisions at the individual level without making the same adjustments at the corporate level where the revenue implications are much more significant.

IV. *Personal Exemptions*

Special provisions favoring selected groups of taxpayers have crept in even in the area of the personal exemptions, which were intended to apply on a flat per capita basis. The favored groups are the elderly, the blind, and the very young. Taxpayers over 65 years of age and the blind are entitled to two exemptions; those under 19 (or over 19 if they are attending school) are in effect also granted two exemptions if they earn over $600 per year.

The additional exemptions for the aged and the blind, which amount to about $2 billion on taxable returns, was justified on the ground that these taxpayers have less ability to pay than younger members of the community. This may well be the case, since the aged and the blind are concentrated at the lower end of the income distribution. However, the personal exemptions and the graduated income tax rates were specifically designed to differentiate between the taxpaying abilities of individuals with different incomes.

The aged and the blind would have a valid claim for an additional exemption if it could be shown that they are required to spend more out of a given income than other taxpayers. There are no data on the expenditures of the blind, but the available evidence indicates that a family headed by an individual over 65 years of age does not on the average spend more than other families in the same income group.[28]

Another argument that has been made

"Two Years of Republican Tax Policy", *National Tax Journal*, March, 1955, pp. 2-11; and Carl S. Shoup, "The Dividend Exclusion and Credit in the Revenue Code of 1954", *National Tax Journal*, March, 1955, pp. 136-147.

[26] Assuming the corporate tax is not shifted, a taxpayer subject to a marginal rate of 90 per cent would pay a total of $95.20 on $100 of corporate income ($52 at the corporate level and $43.20 at the individual level). The 4 per cent credit reduces the combined tax by $1.92 to $93.28. By contrast, a reduction in the marginal individual income tax rate of this same individual to 60 per cent would reduce the combined tax to $80.80 ($52 at the corporate level and $28.80 at the individual level).

[27] William F. Hellmuth, "Erosion of the Federal Corporation Income Tax Base," *Federal Tax Policy for Economic Growth and Stability*, *op. cit.*, p. 914.

[28] See *The Taxation of Pensions and Annuities*, a report on H. R. 2948 of the 79th Cong., 2d Sess., by the Staff of the Joint Committee on Internal Revenue Taxation, 1946, pp. 19-20, 44-54.

is that the aged find it difficult to obtain employment and, therefore, have less resilience to financial reverses than other taxpayers. However, many other groups of taxpayers are handicapped in one way or another (e.g., physical or mental disabilities, lack of opportunity to receive training, etc.), and it would be impossible to take account of all these individual differences under an income tax.

The double exemption which is granted to some children was adopted to avoid a peculiarity arising from the definition of a dependent. Under the per capita exemption system as originally enacted, a taxpayer was entitled to one exemption for each dependent having gross income of less than $600, if he provided more than one-half of the dependent's support. This meant that, as soon as the dependent's income rose above $600, the taxpayer lost an exemption. The resulting increase in tax created considerable resentment among taxpayers. Newspapers and tax services never tired of cautioning taxpayers to limit the income of their children to less than $600 during the summer vacation in order to avoid the loss of their exemptions. To remedy this situation, the 1954 Code eliminated the $600 income test for determining the dependency status of children under 19 years of age (and those over 19 who are still attending school), and taxpayers were permitted to claim the exemption so long as they provided more than half of their support. This revision reduced the tax base by an estimated $300 million.

The difficulty with this solution is that it increases the exemption from $600 to $1,200 for those who are least entitled to it. Only one exemption is granted for children who earn no income, whereas two full exemptions are granted for children earning $600 or more. An alternative solution, which would be admittedly more complicated from a compliance standpoint but which would avoid the loss in revenue, would be to require a taxpayer to include in his return the amount of income received by any person whom he claims as a dependent. The need for accounting for small amounts earned by dependents (e.g., earnings of children from newspaper routes) could be avoided by disregarding the first $100 or $200 of income earned by dependents. This method of handling the problem would restore to the tax base not only the $300 million lost under the 1954 amendment but also another $300 million that had escaped taxation under the old law as well.

V. *Rates*

Although the present rate schedule is graduated rather steeply, especially in the lower income brackets, it is in fact much less progressive for a large group in the taxpaying population than it appears to be. The nominal rates actually apply only to single persons; married couples are permitted to split their incomes for tax purposes and, as a result, are subject to an entirely different—and substantially lower—rate structure.

This difference in the treatment of single persons and married couples arose out of the historical accident that eight states had community property laws which treated the income of either husband or wife as belonging half to each. By virtue of several Supreme Court decisions, married couples residing in these eight states had been splitting their in-

comes and filing separate federal returns. Shortly after World War II, a number of other states enacted community property laws for the express purpose of obtaining the same tax advantage for their residents, and other states were threatening to follow suit. In an effort to restore geographic equality in tax burdens and to prevent the wholesale disruption of local property laws and procedures, the Congress universalized income splitting in 1948.

Income splitting reduces progression because it, in effect, doubles the width of the taxable income brackets for married persons. For example, a married couple with taxable income of $4,000 splits this income and applies the first bracket rate of 20 per cent to each half; without income splitting, the first bracket rate would apply to the first $2,000 and the second bracket rate of 22 per cent would apply to the next $2,000. Thus, whereas the nominal rate brackets cover taxable incomes up to $200,000, the actual rates for married couples extend over $400,000 of taxable income. The tax advantage rises from $40 for married couples at the top of the second bracket to a maximum of $25,180 for married couples with taxable incomes of $400,000 or more.

Some argue that this reduction in progressivity was justified on the ground that married couples in community property states had already been taking advantage of income splitting. According to another school of thought, the geographic equalization of tax liability achieved under income splitting can be realized without at the same time reducing progressivity. The technique would be to continue to permit married couples to split their incomes, but require them to use a rate schedule with brackets exactly half as wide as the brackets applying to single persons.[29] This revision would not alter the tax base, but it would increase revenues from the present rates by $3.9 billion.

The difference between these two schools of thought cannot be resolved on *a priori* grounds. The real issue is not whether income splitting as a device to achieve geographic equality in tax burdens is desirable, but whether the distribution of tax burdens by income levels under the present arrangement is equitable. Those who would retain the present brackets approve the present tax distribution. Those who would halve the brackets believe that the $3.9 billion tax reduction going to married couples in the higher income brackets is unwarranted. Since this disagreement is a matter of rates alone, estimates of the rate reductions that might be made as a result of the removal of the leakages from the tax base will be presented both with and without the proposed change in the size of the taxable income brackets.[30]

[29] For an explanation of this technique, see Joseph A. Pechman, "Individual Income Tax Provisions of the 1954 Code", *National Tax Journal*, March, 1955, p. 129.

[30] Another problem arising under present law is that single persons who run a household (either because they are widowed or divorced) believe that they too should be entitled to income splitting. They argue that they must spend at least as much as married persons and, in many cases, must spend more, because they are required to hire domestic servants to look after the children and do the household chores while they are at work. To meet this criticism, Congress enacted in 1951 a new rate schedule for "heads of households" which provided half the advantages of income splitting. There has been considerable dissatisfaction with this makeshift arrangement, largely because single persons with family responsibilities believe they should have the full advantages of income splitting instead of half. In 1954, the Treasury Department recommended that full income splitting be extended to single

(See next page)

VI. *Compliance and enforcement*

Until recently, there has been little concrete information regarding the level of taxpayer compliance, but the gap has been partially filled by the sample audit study conducted by the Internal Revenue Service for the year 1948.[31] This study revealed that, if each of the 52.1 million returns filed in 1948 had been audited as carefully as the sample returns, the government would have collected an additional $1.4 billion from 12.5 million taxpayers who understated their tax liabilities, and would have been required to refund somewhat less than $100 million to 1.2 million taxpayers who overstated their tax. The net understatement of tax amounted to about $1.3 billion, or 8.5 per cent of the $15.4 billion reported by taxpayers on their 1948 returns. On the assumption that the same percentage holds for 1956, the net understatement now amounts to over $2¾ billion annually.

Many of the errors disclosed by the study were small, suggesting either carelessness or insufficient knowledge on the part of the taxpayer. However, the average error was large and cannot be attributed entirely to these causes. For the millions of returns in error, the average error amounted to about one-fifth of the total tax voluntarily reported. Thus, although the majority of returns are correctly filed, there is a substantial enforcement problem in connection with those that are incorrect.

Improvements in enforcement techniques are frequently made by the Internal Revenue Service, with the result that the resources available for auditing returns are steadily being more effectively utilized. However, the number of people available for enforcement is insufficient to do the job adequately. It was estimated that, with the 1951 staffs and procedures, about 11 million of the 13.7 million erroneous returns filed in 1948 would not be adjusted.[32] Since the number employed by the Internal Revenue Service has declined since 1951,[33] it may be inferred that millions of erroneous returns continue to be unadjusted each year. An additional investment by the government in enforcement personnel is, therefore, likely to pay large dividends, not only by increasing current revenues but also by improving taxpayer compliance in the future.

Consideration should also be given to an extension of the withholding system in order to supplement the increased enforcement effort. Withholding has produced almost perfect compliance by recipients of wages and salaries, largely because it is an automatic, self-enforcing device. Thus, Mrs. Goldsmith has estimated that, in 1946, about 95 per cent of total wages and salaries was reported on tax returns; by contrast, tax returns accounted for only 76 per cent of dividends, 71 per cent of entrepren-

persons who supported parents, children, grandchildren, brothers, and sisters. Although the proposal was adopted by the House, it was eliminated in the Senate. The experience with the present head-of-household provision suggests that the rate distinction now made among taxpayers on the basis of marital status cannot long survive. It would be desirable either to adopt the Treasury proposal or to extend the advantages of income splitting to all taxpayers. For an extended discussion of this question, see *ibid.*, pp. 126-131.

31 The study was conducted on the basis of a stratified sample consisting of about 160,000 tax returns. Field agents visited each individual or married couple in the sample and subjected their returns to a full field investigation. For a detailed description of the sample and a summary of the results, see Marius Farioletti, *op. cit.*, pp. 65-78.

32 See Marius Farioletti, *op. cit.*, p. 66.

33 See the *Annual Report of the Commissioner of Internal Revenue*, fiscal years 1951-55.

eurial incomes (farm and nonfarm), 45 per cent of rents, and only 37 per cent of interest.[34] Holland and Kahn have made similar estimates for 1952, which generally confirm Mrs. Goldsmith's results.[35] Although part of the unreported amounts are received by individuals with gross incomes of less than $600 who are not required to file returns, the large discrepancy between the coverage of wages and salaries on the one hand and other income items on the other can be explained only by the withholding system.

It is not practical to withhold tax from all income payments, but workable methods have been devised for interest and dividends. The most recent plan considered by the Congress provided that payors of interest and dividends would withhold a flat percentage (depending on the first bracket rate) of each payment, without exemptions.[36] Unlike the wage withholding system, the payor would not have been required to prepare withholding statements to account for the amount paid and the tax withheld. Instead, the recipient would have reported the net amount he received and would then have "grossed up" this amount by a factor depending on the withholding rate to obtain the total amount he received before the tax was withheld. For example, assuming a withholding rate of 20 per cent, the grossing up factor would have been 25 per cent. This procedure would have added a few additional lines to the return form, but the steps were simple and would not have complicated the return form unduly or created any serious compliance problems. The Treasury Department estimated that the plan would have added about $250 million in revenue annually, without increasing administrative costs significantly.

The major objection raised against the proposal was that many interest and dividend recipients would have been subject to withholding even though they were not taxable. (This was necessary because corporations had previously complained that it would be too costly for them to withhold on interest and dividends in the same way they withhold on wages and salaries.) The reply to this objection was that taxes are withheld from the earnings of over 8 million nontaxable wage earners annually, yet few complaints are received. Whether the problem is more serious with interest and dividends than with wages is a matter of judgment, but the experience to date suggests that the public accepts overwithholding so long as refunds are paid promptly.

The audit study of the Internal Revenue Service indicated that over a half million returns in 1948 contained errors in dividends and that almost 2 million returns contained interest errors. Noncompliance by such large numbers of people cannot be completely checked by the usual audit and investigating procedures. Even if withholding produced no better reporting of interest and dividends, the enforcement problem would be substantially reduced, since the Internal Revenue Service would not be required to check the amounts reported by the mass of taxpayers with incomes subject to the first bracket rate. This

[34] Mrs. Selma F. Goldsmith, "Appraisal of Basic Data Available for Constructing Income Size Distributions," *Studies in Income and Wealth*, Volume Thirteen, National Bureau of Economic Research (New York, 1951), p. 302.

[35] Daniel M. Holland and C. Harry Kahn, "Comparison of Personal and Taxable Income," *Federal Tax Policy for Economic Growth and Stability*, *op. cit.*, pp. 313-338.

[36] This plan was adopted by the House in 1951, but was eliminated by the Senate.

saving in personnel and cost could be used for more intensive investigation of returns in the higher income brackets and of the other income receipts which must be handled on an audit basis rather than through a withholding system.

VII. *Summary and Conclusions*

The estimated amounts of income and tax accounted for by the leakages discussed above are brought together in Table 5.

At 1956 income levels, the measurable leakages probably amount to more than $43 billion, or almost one-third of the $136-billion tax base under present law. This increase in the base, combined with the revenue that could be

TABLE 5

ESTIMATED EFFECT OF LEAKAGES ON THE BASE AND YIELD OF THE INDIVIDUAL INCOME TAX, 1956

(Billions of dollars)

Item	Effect on Tax Base	Effect on Yield
1. Present law base and yield	136.0	32.5
2. Add: Effect of leakages	43.2	12.0
a. Deductions		
(1) Contributions	4.0	1.0
(2) Interest	4.0	1.0
(3) Taxes	4.4	1.1
(4) Medical and dental expenses	0.5	0.1
(5) Standard deduction	10.1	2.4
Total deductions	23.0	5.6
b. Exclusions		
(6) Transfer payments and fringe benefits	8.5	2.1
(7) Net imputed rent of owner-occupied homes	4.0	1.0
(8) Home produced food consumed on farms	0.4	0.1
(9) Deferred compensation, stock options, expense accounts	*	*
(10) Interest on state and local government bonds	0.5	0.2
(11) Interest on life insurance savings	1.1	0.3
(12) Capital gains	2.2	0.9
(13) Dividend exclusion	0.2	**
(14) Percentage depletion and exploration and development expenses	0.7	0.4
Total exclusions	17.6	5.0
c. Exemptions		
(15) Additional exemption for aged and blind	2.0	0.5
(16) Additional exemption for children earning income	0.6	0.1
Total exemptions	2.6	0.6
d. Tax credits		
(17) Retirement income credit	....	0.1
(18) Dividend credit	....	0.4
Total tax credits	....	0.5
e. Enforcement		
(19) Inadequate enforcement budget	....	*
(20) Absence of withholding on interest and dividends	....	0.3
Total enforcement	....	0.3
3. Equals: Base and yield assuming elimination of leakages (line 1 + line 2)	179.2	44.5
4. Add: Effect of removing rate advantages of income splitting	....	3.9
5. Equals: Base and yield, assuming elimination of leakages and of rate advantages of income splitting (line 3 + line 4)	179.2	48.4

* No data available to estimate these items.
** Less than $50 million.

added by eliminating the tax credits for retirement income and dividends and by extending withholding to interest and dividends, would raise the total yield of the present rate structure to $44.5 billion—an increase of 37 per cent over the present $32.5 billion yield. If, in addition, the taxable income brackets for married couples were halved to remove the rate advantages of income splitting, the yield would be increased to $48.4 billion—an increase of almost 50 per cent over the present yield. Alternatively, the present yield could be maintained and the tax rates could be reduced by an average of 25 per cent or 33-1/3 per cent, depending on whether the rate advantages of income splitting would be eliminated along with the other leakages.

When translated into actual tax rates, the potential reductions that might be made are impressive. At the present time, the rates begin at 20 per cent on the first $2,000 of taxable income and rise to a maximum of 91 per cent on taxable incomes in excess of $200,000. If the rates were reduced proportionately by 25 per cent, they would range from 15 per cent in the first bracket to 68 per cent in the top bracket. If they were reduced by a third, they would range from 13 per cent to a maximum of 61 per cent.

Although the calculations are admittedly rough, I believe that they understate the rate reductions that could be financed by a determined effort to remove all the preferential provisions in the tax law. In the first place, the estimates were made on a very conservative basis. Second, estimates of the revenue effect of a number of important leakages, in particular, those due to deferred compensation and liberal expense accounts, are not included because of the lack of information. Third, a substantial amount of additional revenue can be obtained by devoting more resources to tax enforcement. But exact magnitudes are relatively unimportant: it is clear that many persons are being taxed at very high rates because of our failure to tax others on their entire net incomes.

It is also clear from Table 5 that the tax benefits of the preferential provisions are not uniformly distributed. In general, the major beneficiaries are recipients of transfer payments, home owners, recipients of property incomes, the aged, corporate executives, and the self-employed (including farmers). The group which suffers most is the large mass of employed wage earners and salaried personnel below the executive level who rent the living quarters in which they reside. They are forced to report their entire incomes, due to the operation of the withholding system, and rarely have deductions in excess of the standard deduction. By contrast, the other groups benefit from one or more legislative concessions and also account for the major share of the under-reporting of incomes or overstatement of deductions on tax returns.

PROBLEMS OF DEFINITION UNDER THE CAPITAL GAINS TAX *

RICHARD E. SLITOR **

Introduction

DEFINITIONAL aspects of the capital gain treatment have been the objects of particular attention in recent years both in the British Commonwealth countries and in the United States. Concern with this problem has taken diverse forms and directions in the different countries, including fears that a traditional area of exemption or special treatment was being constricted, that it was being broadened beyond the limits of logic or reason, that the conspicuous outcropping of capital gain oases in the desert of progressive rates may distract the ordinary income laden wayfarer beyond endurance, and that alleged definitional anomalies, inconsistencies, and uncertainties may so baffle and bemuse the taxpaying public that they will lose essential faith in the income tax system.

An active discussion of capital gain questions in Canada has taken place against the background of great expansion in the Canadian economy. The Canadian literature has referred, for example, to concern over a reported widening of the taxable gain concept in Canada to comprehend occasional profits from real estate and stock exchange transactions. At the same time, there have been reassurances that the increased volume of capital gain cases are due to the period of high prosperity in Canada as well as certain appeal procedures, and that, while capital profits are sometimes taxed when derived from adventures in the nature of trade, the underlying law in Canada remains the same: capital gains, including occasional gains from securities and land, are still not taxable as income.[1]

In other British Commonwealth countries, particularly the United Kingdom, critical scrutiny has recently been given to the exemption of casual gains not derived from trade, based largely on court-made rules. In part, this has taken the form of criticism of the uncertainty in the delineation of the exempt class of gains.

For Americans accustomed to a detailed statutory delineation of the capital gains area, it is sometimes difficult to appreciate the full extent to which Britain, Canada, and the other Commonwealth countries rely on general principles effectuated by administrative

* This article is based on a paper presented by the author at the Tenth Tax Conference of the Canadian Tax Foundation, 1956, as part of the Income Tax Panel Discussion on "Can Capital Gains Confusion be Removed by Legislation?," held at Montreal, November 12, 1956.

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[1] See Robert Tresilian, "The Capital Gains Scare," *Canadian Tax Journal*, Vol. III, No. 6 (November-December, 1955), pp. 396-398, and accompanying reprint, Molyneux L. Gordon, "Capital Gains are Sometimes Taxed," *ibid.*, pp. 399-401.

and judicial decisions on a case-by-case basis to distinguish exempt capital gains from ordinary taxable income. The judicial or nonstatutory approach extends not merely to deciding whether particular security, real estate, or other property transactions " wear the badge of trade " but even to identifying the income or capital elements in corporate reorganization situations. However, as previously suggested, there has been some concern over both the principle of disregarding capital gains and the nonstatutory method of definition, including the question whether some capital gain difficulties and uncertainties could be resolved by more precise statutory rules.

Questions of definition have always played a crucial although sometimes implicit role in the discussion of capital gain issues. As we all know, fundamentalists in the income tax credo generally believe that the best definition of capital gains is one which narrows them to the point of extinction. Others, including those who hold aloft the banner of averaging, contend that a tighter, stricter definition of capital gains would confine the breach of regular progressive rates to tolerable limits. Still others maintain that a basic review and purification of the capital gain definition is a necessary prelude to substantive reforms of the capital gains rate, holding period, and other structural features.

This article will certainly not furnish unequivocal answers to these questions even in terms of the United States experience and least of all for the situation in other countries. Rather, it will be confined to highlighting some of the problems and issues in the current definition of capital gains under United States tax law.

Capital gains treatment in the sense of a statutory area of preferential taxation has always taken a fearful beating at the hands of those economists and tax experts who hold to a monolithic concept of income. In this light, some allowance must be made in evaluating current criticism directed specifically at the alleged uncertainty and unresolved definitional problems which are said to confront tax administration, the courts, and legislative policy in the capital gains area under the United States tax law. Such problems, of course, have received increased attention as the scope of the capital gains system has expanded and the pressure of tax rates has risen. However, the capital gains area can hardly be considered unique in this respect.

The American capital gains area is broader in some respects and narrower in others than the casual gains of the British Commonwealth countries.[2] Since the American capital gains treatment consists of a reduced rate of taxation rather than complete exemption, the tax stakes involved are lower. Other things being equal, of course, the exemption of capital gains makes for a more difficult definitional problem, in the sense of holding the line against the infiltration of ordinary income, than merely the application of a reduced rate. Nevertheless, whether the objective is to mark out an area of exemption or of differential taxation, many of the problems of definition, including safeguards against conversion of ordinary income

[2] Broader, for example, because of the extensive statutory definition of capital assets for gain purposes and the inclusion of trading activities which do not constitute dealership; narrower, because of the operation of the 6-months' holding period in excluding from preferential treatment some profits which would qualify as exempt casual gains in the British Commonwealth.

into capital gains, are similar under both systems. One difference is that under the Canadian treatment, the individual apparently enjoys a more favorable position for qualifying for capital gain treatment than the company, which is presumptively in trade and out for profit in all its transactions.[3] In the United States, individuals and corporations are essentially on a par vis-a vis capital gain qualifications.

Conflicting Views on Definitional Problems

A quick survey will illustrate the sharp differences of opinion which may exist with respect to the clarity of capital gain definitions under either a judicial, case-by-case approach or a statutory system.

On the one hand, there is recognition that by painstaking statutory provisions the U. S. tax law has helped minimize the tasks of administrative and judicial determination that have allegedly beset countries which on broad principle exempt " casual " gains. On the other, is the contention, which has had very positive advocates, that the lengthy capital gain and loss provisions of the U. S. Internal Revenue Code are singly responsible for the largest amount of complexity in the tax laws, that the statutory definition has presented a difficult job to the courts, and that eventually it may become necessary to resort to a transaction-by-transaction classification.[4]

Curiously enough, this prospect, held out as a bleak object lesson by an American critic of the U. S. capital gains system, bears at least a family resemblance to a conclusion favored by a majority of the recent British Royal Commission on the Taxation of Income and Profits: namely, that each case must be decided, in the light of relevant criteria, according to its own circumstances.[5] At the same time, a dissent to the same Royal Commission Report indicated the status of " casual " and " capital " profits had been a matter of uneasiness in Britain for at least 40 years, and that the accession of case law, instead of evolving a clear principle, had left greater uncertainty about the status of nontaxable capital profits without effecting any notable advance towards equity.[6] Even back in a simpler era when tax issues were less pressing, one British judge commented in 1938 that in many capital gains cases " the spin of a coin would decide the matter almost as satisfactorily as the attempt to find reasons." [7]

Different Aspects of the Definitional Problem

The term "definitional problem " includes, of course, questions of fact and administrative determination as well as underlying issues of concept and rationale. Many so-called definitional problems are actually matters of value judgment on such questions as the desirability

[3] See R. deWolfe MacKay, " Corporation Gains," *Canadian Tax Journal*, Vol. I, No. 1 (January-February 1953), pp. 13-21.

[4] See Stanley S. Surrey, " Definitional Problems in Capital Gains Taxation," *Harvard Law Review*, Vol. 69, No. 6 (April 1956), pp. 985-1019 (based on a paper appearing in *Federal Tax Policy for Economic Growth and Stability*, Joint Committee on the Economic Report, 84th Cong., 1st Session, 1955).

[5] Royal Commission on the Taxation of Profits and Income, Final Report, June 1955, Command 9474, p. 39.

[6] *Ibid.*, Memorandum of Dissent by Messrs. Woodcock, Bullock, and Kaldor, pp. 358-359.

[7] Sir W. Greene, Master of the Rolls, in British Salinson Aero Engines, Ltd. v. I.R., 22 T.C. 29.43 (1938), cited in J. Harvey Perry, " Capital Gains: The British Point of View," National Tax Association, *Proceedings* of the Forty-Sixth Annual Conference, 1953, pp. 156-157.

of any differentiation among sources of income or gain for tax purposes, or of statutory provisions dubbing particular types of receipts capital in nature. The definitional problem in such cases merely reflects the critic's dissatisfaction with the resulting compromise between clashing considerations of economic effect and incentives on the one hand, and of equity and uniformity of the tax laws, on the other. In this sense definitional problems might persist even though the identification of capital gains was crystal clear and ideally workable from the practical standpoint.

Background of the Capital Gain Concept

The American tradition has always included capital gains in the measure of taxable capacity, although since 1922 the tax law has recognized a distinction between capital gains and ordinary income in the sense that such gains should not bear the full weight of progressive rates for individuals.[8]

Still earlier distinctions under the American income tax law between capital and ordinary transactions had been made on the side of losses to deny or limit their deductibility.

The preferential treatment of "net long-term gains" at the present time consists of permitting the individual taxpayer to deduct one-half the gain and limiting the effective tax on the gain for both individuals and corporations to 25 per cent.[9]

[8] For corporations, both long-term and short-term net capital gains continued to be included in ordinary income subject to regular income tax rates until 1942.

[9] Individuals may deduct capital losses, including net short-term capital losses, first from capital gains and then to the extent of $1,000 each year against ordinary income, subject to a 5-year carry-forward of unabsorbed losses. For corporations, the deduction of capital losses is limited to capital gains.

Rationale of U. S. Capital Gains Taxation

Basically, the U. S. capital gains concept singles out a form of gain which the investor, by reason of its previous inclusion as unrealized appreciation in his net worth, tends to regard as part of his capital. This echoes at least faintly the British tradition with respect to casual gains, based on the agricultural concept of annually recurring income and concern with the preservation of capital in the form of the landed estate. The American concept as it stands today also embodies the traditional distinction between the tree and its fruit plus the segregation of investment from business or speculation. The U. S. approach has always recognized the averaging problem in taxing the realization in a single year of gain accrued over a period of years. The capital gains feature is also utilized in lieu of specific averaging devices in areas outside the hard core of capital gains to mitigate the impact of progressive rates on bunched income.

In some instances, the capital gains definition is extended to certain types of income, such as patent royalties, as a deliberate concession for incentive purposes or to minimize hairline distinctions. In other situations, such as coal royalties, it has been used to relieve certain economic pressures and remove discrimination as compared with other industries already benefiting from capital gain treatment.

Behind the basic conceptual benchmarks of the capital gain system is a shifting and evolving economic rationale comprising (1) encouragement to fluid capital markets and investment portfolios, (2) the practical revenue consideration that a reduced rate may

be more effective where it is within the taxpayer's discretion to avoid tax by not realizing his gain, (3) the practical necessity of limiting capital loss offsets, and (4) the "safety-valve" theory which accepts the capital gain differential at least on an interim basis pending possible readjustment of high surtax rates.

The rationale of capital gains taxation unquestionably has deep roots in the economic environment and traditions of the community. Whatever the relationship between this and the more immediate practical problems of definition, the significance of the economic background presents some puzzling and contradictory aspects. The *taxation* of capital gains in the United States has been interpreted as the logical outcome of the functioning of a youthful, dynamic economy with undeveloped resources, in which capital gains, including some whose origin is in reinvested corporate profits, can be made easily, are a familiar part of the economic landscape, and constitute an important source of private fortunes.[10] Conversely, the *exemption* of capital gains has been frequently justified in Canada to assist the development of a young, vigorous country, protect incentives, and safeguard the accumulation and free movement of private capital.

Key Elements in the Definition of Capital Gains

While the exact definition of the capital gains area has expanded over the years, the three basic tests under U. S. tax law have always revolved around (1) the definition of capital assets, (2) realization on sale or exchange, and (3) the holding period. To qualify for differential treatment, there must be a capital asset, or at least an "honorary" capital asset for this purpose. The gain or loss must be realized in a sale or exchange, or through some other event which is treated as an "honorary" sale or exchange for this purpose. Finally, to be eligible for preferential treatment, the asset must generally have been held for a period of more than six months.

The terms "qualify" and "eligible" may be misleading, for the capital provisions are a privilege only where the transaction results in a gain. They constitute a limitation where there is a loss.

To compare the statutory tests under U. S. law with the six relevant criteria for identifying capital gains suggested by the majority in the 1955 British Royal Commission Report,[11] the U. S. statute defines specifically (1) the subject matter of realization, and (2) the length of period of ownership. Generally, it rules out property created by the work of the seller. In certain factual determinations, such as those pertaining to dealer status and certain corporate distributions, the U. S. capital gain treatment also inquires into (3) the frequency or number of transactions by the same person, (4) supplementary work on or in connection with the property realized, (5) the circumstances responsible for realization, and (6) motive.

Basic Definitional Problems

The classic problems in delineating capital gains under American tax law involve distinguishing bona fide capital

[10] See A. R. Ilersic, "Capital Gains Taxation in the United Kingdom," *Canadian Tax Journal*, Vol. III, No. 2 (March-April 1955), p. 126. This view has been expressed by Lawrence H. Seltzer in *The Nature and Tax Treatment of Capital Gains and Losses*, National Bureau of Economic Research, 1951.

[11] *Op. cit.*, pp. 39-40.

transactions from (1) business and dealer activities, (2) speculation, (3) compensation for personal services, (4) mere assignment of future income in the guise of sale of an intangible capital asset, (5) withdrawal of accumulated profits from corporate solution in the form of capital gains, and (6) various artificial devices designed merely to transmute ordinary income into capital gains.

Capital Assets Classification

Section 1221 of the Internal Revenue Code of 1954 defines a capital asset to mean any property, whether or not connected with the taxpayer's trade or business, other than: (1) stock in trade or other property properly included in inventory, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, (2) a copyright, a literary, musical or artistic composition, or similar property held by the taxpayer whose personal efforts created it or by someone to whom he has transferred such property as a gift, (3) accounts or notes receivable acquired in the ordinary course of trade or business, (4) certain federal, state, or local obligations issued on or after March 1, 1941, on a discount basis, with a maturity of one year or less from date of issue. These significant exclusions deny capital gain treatment to business income, certain forms of compensation for personal effort, and certain interest income.

Depreciable property and real estate used in the taxpayer's trade or business are also excluded from the definition of a capital asset, but by specific provision (section 1231)[12] are treated like capital assets if held for more than 6 months and a net gain is reported for all transactions in such property. Where an over-all net loss results, it is treated as an ordinary loss.

This hybrid capital gain-ordinary loss treatment applies also to certain income from timber or coal, livestock held for draft, dairy, or breeding purposes and held for more than 12 months, and unharvested crops sold along with the land at the same time and to the same person.[13]

Generally speaking, the individual reports as capital his gain from sale of almost any nonbusiness property, including stocks and bonds, real estate and other investments, his residence and personal property such as an automobile, consumer durables generally, art objects, and so forth.

Specific statutory provisions elsewhere treat as capital in nature receipts from dealings in certain options to buy or sell, patents, lump-sum settlements under employee pension plans as well as certain other employment termination payments, certain distributions in complete or partial liquidation of a corporation, capital gain dividends of a regulated investment company, and restricted employee stock options.

Sale or Exchange Test

Sale or exchange is the second major element in the definition of a capital gain or loss. No tax is levied and no loss is recognized unless actually realized through sale or exchange, or its statutory equivalent. A sale or exchange generally has the same meaning

[12] This and other section citations in this paper refer to the United States Internal Revenue Code of 1954.

[13] For a recent summary of these provisions and their historical background see *The Federal Revenue System: Facts and Problems*, materials assembled for the Subcommittee on Tax Policy by the Subcommittee staff, Joint Committee on the Economic Report, 84th Cong., 1st Sess., pp. 18-19.

for capital gains tax purposes as in everyday business parlance. However, the statute has extended honorary sale or exchange status to a number of other transactions for purposes of establishing capital gain or loss, including (1) redemption of a bond by the issuer, (2) worthlessness of securities, (3) retirement of stock on liquidation of a corporation, (4) failure to exercise an option relating to a capital asset, (5) cancellation of a lease or distributorship which is a capital asset, (6) the receipt by an employee of capital-gain type retirement benefits, (7) the incurring of losses on nonbusiness bad debts, (8) foreclosures, and (9) some involuntary conversions.

Holding Period Test

The six months' holding period is primarily an automatic device for excluding speculative gains. However, the speculator thus debarred from the capital gains fold is not necessarily a trader. Moreover, the line thus drawn between investment and speculation is necessarily arbitrary.[14] Incidentally, the holding period also tends to curb artificial devices for converting income into capital gains.

Specific Definitional Problems

Capital gain vs. business income

The task of excluding business or merchandising and stock-in-trade sales involves several related aspects: (1) the determination of who is a dealer, (2) the exclusion of dealers from capital gain treatment on their business transactions while permitting such treatment on bona fide personal investment holdings, and (3) checking the translation of unrealized appreciation on business inventory or accounts receivable into capital gains.

Dealer status and dealers' investment accounts

U. S. tax law makes no attempt to deny capital gain treatment to the "trader" provided his transactions do not fall into the class of speculation by virtue of the six months' holding period requirement.

It is ordinarily not very difficult to distinguish a dealer from a trader in the securities field, which accounts for some three-fourths of all capital gains in the United States. A securities dealer is a merchant who buys securities as his stock in trade to sell at a profit, not due to a rise in the market but to the dealer's margin between buying and selling prices at any market level.

By contrast, the trader in securities does not perform merchandising functions. He operates in a market equally accessible to others as it is to him. He relies, therefore, on a market rise and favorable timing of purchases and sales to obtain a gain.

In the real estate field, however, the problem of distinguishing the investor-trader from the dealer is more difficult. Specific provisions have been adopted, however, to help in determining whether or not certain real estate sales place the taxpayer in dealer status.

One of the perennial problems in this field prior to the 1954 Code was the status of an individual, not otherwise a real estate dealer, who subdivides real property held for investment because that is the most advantageous way to dispose of it. Under the old law, he ran a risk of being considered a dealer solely on account of such subdivision

[14] See Charles Klem, "The Stock Exchange Point of View on Capital Gains Taxation," National Tax Association, *Proceedings* of Forty-Sixth Annual Conference, 1953, p. 142.

activity and so subjected to ordinary income tax rates on the entire gain. To relieve this situation, the 1954 Code made definite rules respecting the sale of subdivided real estate by a nondealer (section 1237).

Under these rules, the subdivider may qualify for capital gain treatment on the first five sales of lots from a single tract. Beginning in the year the sixth sale is made, the gain up to 5 per cent of the selling price (the typical real estate broker's commission) must be reported as ordinary income, the balance, if any, being treated as capital gain. Selling expenses are deductible first against the ordinary gain, and any excess is applied to reduce the capital gain portion of the proceeds.

To qualify for this treatment the taxpayer must not have made a substantial improvement in the property and must have held it for at least five years. However, in the case of inherited property no holding period is required. In cases where the property has been held over ten years, the taxpayer may make certain improvements without disqualifying the sale from capital gain treatment. These include installation of certain utilities and access roads, if required by local market conditions to obtain a fair price, provided the taxpayer agrees not to add the cost of such improvements to the cost basis of the property.

In the field of both securities and real estate there is the problem of segregating the investment holdings of a taxpayer who is also a dealer in the same type of property.

Personal investment accounts of dealers are dealt with by specific statutory provision (section 1236). This provides that in no event shall gain from sale of a security by a dealer be considered capital gain unless the security was, within 30 days after its acquisition, clearly identified in the dealer's records as held for investment account, and was not subsequently held for sale to customers. Losses on securities so identified for investment account are, of course, capital losses.

The problem of identifying bona fide personal investment holdings remains, however, in the real estate field. Whether or not real estate held by a dealer may qualify as an investment eligible for capital gain treatment, depends on all the facts and circumstances of its acquisition, holding, and manner of disposition.

In connection with the reform of the tax laws in 1954, the House bill contained a section, drawn on the lines of the security dealer's investment account provisions, providing that real estate gains of noncorporate real estate dealers might be treated as capital gain under specified conditions. This proposal was criticized as being unduly restrictive, and it was eliminated.

Suppose rental property is held by a real estate dealer. What are some of the considerations relevant to the treatment of gain on its sale? Although such property may have been originally acquired for investment it may be held later for sale to customers in the ordinary course of business. Frequency and continuity of sales are important considerations.

Apparently, the disposition of a large rental project in a single sale to one buyer is not likely to be regarded as sale to customers in the ordinary course of business. Where there are multiple sales, the availability of capital gain treatment seems to depend on whether the sales (1) constitute the liquidation of the rental project, (2) are made pri-

marily not as a money-making activity in themselves but for the purpose of disposing of the investment, (3) are accompanied by promotional, advertising and sales activities characteristic of real estate dealers, and (4) are made with a view to making replacement purchases so as to continue the cycle.

Collapsibles and conversion of inventory profit

The main definitional problem posed by inventory items has been the possibility of selling inventory or stock in trade as part of a business interest. One technique was to incorporate the appreciated inventory and sell the stock of the corporation. Another was to sell the inventory under the cover of a partnership interest. These devices for transforming inventory profit into capital gain come under the general heading of "collapsible" corporations and partnerships. Provisions dealing with the collapsible corporation device were refined and related provisions applied to collapsible partnerships under the 1954 Code (sections 341 and 751). In the case of a proprietorship, the rule that the proceeds of the sale of the business must be allocated among the underlying assets and the type of gain determined by the character of the asset generally precludes the possibility of disguising inventory profit.

The recent Supreme Court decision in the *Corn Products* case [15] is a significant development in the differentiation between business income and capital gains. The taxpayer purchased corn for future delivery as insurance against increases in the price of corn used in its manufacturing operations. It sold some of these commodity futures at a gain. The court concluded that although these futures did not literally come within the statutory exclusions from capital assets, the gain must be considered ordinary business profit.

One of the reasons indicated by the court was the necessity of interpreting the definition of capital assets narrowly in accordance with the purpose of relieving shifts in investments and broadly in accord with the Congressional purpose of excluding business income. The court further pointed out that any other decision would leave the taxpayer in position to transmute ordinary income into capital gain at will, since the futures hedger had a choice between selling the futures contract at a gain or accepting delivery of the corn at a price which would be reflected in manufacturing profits.

Compensation for personal services

In general, the U. S. capital gains definition excludes amounts derived from personal efforts embodied in a copyright, a literary, musical, or artistic composition, or similar property in the hands of its creator.

A special exception has been made for patents, whether the proceeds are received in a lump sum or royalties. Prior to the 1954 legislation, there was considerable uncertainty whether patent transactions providing for royalty payments represented the sale or exchange of a capital asset and, therefore, whether the proceeds were capital gain or ordinary income. In general, an amateur as distinct from a professional inventor could obtain capital gain treatment provided the sale arrangement resulted in installment payments for complete divestment of an interest in the patent rather than royalty payments contingent on its productivity. However, it

[15] *Corn Products Refining Co. v. Commissioner*, 350 U. S. 46 (1955).

was not always easy to determine whether the inventor was an amateur or whether the payments were proceeds of sale.

In 1954 definite provisions (section 1235) extended capital gain treatment to proceeds realized by an inventor, regardless of whether amateur or professional, and regardless of whether the purchase price takes the form of royalty payments, provided the seller transfers all substantial rights to a patent or an undivided interest therein. The same treatment applies to pioneer financial contributors to the development of the invention before it is reduced to practice.

The use of employee stock options as a means of giving incentive to corporate executives has presented problems as to the nature of the income involved (capital gain or compensation) and the timing of its realization (receipt of the option, its exercise, or resale of the stock acquired). The problem has been to accord capital gain treatment where appropriate and yet curtail opportunities to disguise executive compensation in the form of virtually assured capital gains by purchase of stock at bargain prices. Capital gain treatment has been accorded on resale of stock acquired by stock options restricted to employees, subject to specific rules and conditions designed to make clear the status of any employee stock option plan, prevent abuse, and yet preserve the usefulness of the employee stock option as a method of encouraging employee loyalty and incentive. These rules were clarified and adapted to the special situation of so-called variable price options in 1954 (section 421).

Capitalization of future income

One of the current definitional problems arises from the possibility of converting rights to future income into a form of intangible property which can be marketed as a capital asset. An illustration is the sale of oil and other mineral production payment rights, carved out of a larger property interest. Recent court decisions have made proceeds of such sales eligible for capital gain treatment. A similar situation has developed with respect to the sale of a life interest by the life tenant to the remainderman. This poses questions of income concept in such areas and of future trends in the definition of capital gains. A recent report prepared by the Treasury and Congressional tax staffs suggests that proceeds of sale of carved-out oil and mineral interests be taxed as ordinary income.[16]

Corporate distributions

The definitional problems relating to corporate distributions and liquidations are sometimes described as the most formidable in the whole capital gains area. The problem here is, of course, to distinguish between distributions and redemptions which are merely dividends from accumulated earnings and those which are bona fide liquidations or contractions of the corporate business. The Canadian tax law has cut this Gordian knot with its 15 per cent tax on certain stock redemptions and capitalizations of earned surplus.

Under U. S. tax law, distributions in complete liquidation of a corporation are usually treated as full payment in exchange for the stock, subject to capital gain or loss treatment (section 331).

[16] See *List of Substantive Unintended Benefits and Hardships and Additional Problems for the Technical Amendments Bill of 1957*, prepared by the Staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department, November 7, 1956, Committee on Ways and Means, Subcommittee on Internal Revenue Taxation, p. 1.

Partial liquidations may also qualify if they are not essentially equivalent to a dividend or if they constitute one of a series of stock redemptions pursuant to a plan of liquidation, and if they meet other specific tests indicating that the distribution is a genuine contraction of a business (section 346).

If a distribution does not qualify for capital gain treatment the portion representing the withdrawal of accumulated earnings from corporate solution is taxable as an ordinary dividend. The balance is applied against the basis of the stock in the hands of the shareholder, to measure the resulting capital gain or loss.

Special provisions also deal with other potential devices to siphon off capital gains from corporations bulging with accumulated earnings. More definite and effective rules under the 1954 Code were applied, for example, to so-called spin-offs and bail-outs to prevent withdrawal of accumulated corporate earnings in the guise of capital gains through splitting-off and selling part of the assets of the business as a separate corporation or through stock redemptions (sections 304, 306 and 355).

Capital gain devices

One of the pervasive problems in the special treatment of capital gains is the use of " gimmick " devices to create artificial capital gains or to juxtapose capital gains with an ordinary income deduction, so as to profit tax-wise by the differential between the ordinary and preferential rates.

An illustration of this problem is unrealistically high amortization of premium on a bond with a short-call feature which is not likely to be exercised and resale of the security after six months at capital gain rates. The 1954 Code plugged this loophole by denying amortization with reference to call date on bonds with a call date less than three years from date of original issue (section 171). A suggestion is now under study to require amortization of bond premium over the period to maturity.[17]

Another example is the device of detaching coupons from bonds to create an artificial discount. The purchaser of such a bond can then wait for the passage of the missing coupon dates, and after this " healing period " resell the bond at normal value for capital gains in lieu of ordinary interest. The 1954 Code also dealt with this type of loophole by treating as ordinary income the portion of gain on sale or redemption of the bond due to the removal of coupons payable more than 12 months from the purchase date (section 1232). A suggestion has been made to tighten this provision further by deleting the 12 months' tolerance rule.[18]

Conclusion

In summary, the 1954 Code revision demonstrated that much can be accomplished through legislative rules to eliminate both fuzziness and abuse in the capital gains field. The definitional problem in the modern tax world is a continuing one, particularly where sprawling interrelated areas of capital gains are involved.

There may be areas in which it is necessary to go slowly with hard and fast rules and to rely on broad principles. Specific statutory tests are helpful in many situations but in others may

[17] See *List of Substantive Unintended Benefits and Hardships and Additional Problems for the Technical Amendments Bill of 1957*, November 7, 1956, *op. cit.*, p. 9.

[18] *Ibid.*

involve undue sacrifice of the flexibility which is the opposite side of the coin of "taking account of all the facts and circumstances."

Some capital gain principles are necessarily harder to effectuate than others. For example, the strict dealer concept used in the U. S. tax law in separating ordinary income from capital gains is probably tighter and simpler to administer on the basis of the relevant facts and circumstances than the broader one embracing profits from trade or any adventure in the nature of trade. Some lines of identification probably cannot, by their nature, be drawn any tighter or clearer by legislation than by court-made rules. An appraisal of all the facts, and an over-all evaluation of the extent to which a number of pertinent criteria are met, may be essential to bring about the desired result. To improve matters in these cases, legislation may have to be content with providing occasional presumptive rules. Or it may serve to accelerate or "beef up" a slow or wavering line of judicial development. As a more fundamental alternative, the legislative approach may involve resort to drawing a new line, over smoother terrain, where the facts are easier to determine and apply.

At the conceptual level, the development of a sound, defensible capital gain definition involves balancing of all the economic, equity, and practical considerations. Whatever complexity exists under the U. S. system might, of course, be reduced by a simpler and stricter concept of capital gains since much depends on the length and convolutions of the capital gains boundary to be marked and kept under surveillance. However, the desirability of a consistent hard-core capital gain concept along classic lines as against the acceptance of some heterogeneous or extraneous elements in the capital gains basket is a matter of policy judgment.

So far as my personal conclusions are concerned, there is nothing to indicate that the capital gains structure is at the crossroads because of definitional questions. Capital gain definitions along with other sectors of the income tax have been subjected to severe pressure by prevailing tax rates. Some shifting and broadening of the capital gain area has apparently been a part of the legislative adjustment to high tax levels. However, the lines of demarcation have been clarified and strengthened about as fast as the pressure on them has been intensified by the combination of high tax rates, the greater complexity of business and investment transactions, and the increasing sophistication of taxpayers and their counsel.

PROBLEMS IN THE TAXATION OF FOREIGN INCOME

DAN THROOP SMITH *

THE tax treatment of foreign income has been given increasing attention in recent years. Interest in the subject has by no means been confined to or even centered in the United States. Proposals for changes in tax laws have been numerous in many other countries, including both those which are on balance recipients of income from abroad and the countries which are the source of such income. Unfortunately, the increased attention has not brought any general agreement on the principles to be adopted or on the specific concepts and definitions to be applied in carrying out whatever principles are adopted. My purpose in this article is not to propose any single approach, but rather to review the major issues and to set them in perspective against other aspects of tax policy.

As regards general policies, one extreme would be full domestic taxation of income from foreign sources with no recognition of any prior or simultaneous right of taxation in the foreign country in which the income is earned. At the other extreme would be recognition of an exclusive right of taxation in the foreign country where the income is earned and no domestic taxation of the income in the country to which it is or will be taken; this is sometimes referred to as taxation according to source. Between these two extreme positions are various intermediate ones, including (1) recognition of foreign taxes as a deduction in calculating net taxable income; (2) recognition of foreign taxes as credits or offsets against the domestic tax; (3) postponement of the imposition of a domestic tax until sometime after the income is earned, as when it is transferred out of the country where it is earned, or into the country of its ultimate destination, or merged into the general funds of the owner in the country of ultimate destination. In addition to the foregoing policies, there is also the possibility of imposing a lower rate of tax on foreign than domestic income. A lower rate, if adopted, may be combined with any of the preceding deductions, credits, or postponements.

Various principles are also advocated concerning the extent to which a national tax jurisdiction should be applied to a country's citizens and corporations resident abroad. The problem here is, in a sense, the reverse of the preceding one. The first question, outlined above, is how to tax income from foreign sources to citizens who are presumably resident in the country of their nationality. The second question is how far to tax nonresident citizens on their income from various sources, both do-

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mestic and foreign. A third problem, the tax treatment of aliens, both resident and nonresident, should be recognized for the sake of completeness in the area, but will not be developed in this discussion.

In this second area, the taxation of nonresident citizens and corporations, proposals and practice also cover the full range of possibilities. The most strict policy is to ignore residence and tax all citizens on the same basis, applying to nonresidents the same rules as those used for residents. The most liberal policy is to ignore citizenship and tax only on the basis of residence, or tax nonresident citizens in the same manner as nonresident aliens, which typically would mean taxing only the income from domestic sources and then usually at a flat withholding rate. Various intermedite positions are also possible, including differential treatment of different categories of income or progressive taxation of some of the income.

In this country, our tradition has been to tax our individual citizens and our corporations on all their income from all sources. This seems to be an almost intuitive approach, based perhaps on the all-inclusive nature of our concept of income in the sixteenth amendment and our early income tax laws under it. Exemptions and limitations on this all-inclusive approach seem to be regarded as exceptions which need to be justified at their inception, and perhaps recurringly for their continuation, by special circumstances. In some other countries, especially where income taxation has developed on a schedular basis, or by a succession of extensions to different sorts of income, foreign insome, or the income of nonresident citizens, may not have been included in the earlier versions of the law simply by neglect or oversight, and then come to have an accepted special position simply by the passage of time.

Our exemption from domestic taxation of individual income earned abroad by our citizens who have bona fide residences abroad seems generally accepted as a sound and fair policy in this country. But so also does our policy of taxing our nonresident citizens on all their other income, including investment income, capital gains and business profits. The distinction is not based on absolute logic, as evidenced by the fact that some other countries may exempt their nonresident citizens from the tax on some or all of these additional forms of income. But a proposal for such exemption in this country would be regarded as creating a tax loophole, probably because its adoption would lead to a truly spectacular exodus of citizens to convenient regions where the tax climate is more salubrious.

The prevailing attitudes in different countries on the two general problems outlined above appear to be founded more on tradition and historical evolution than on abstract logic. Certain policies or specific items of legislation may be related to broader economic or political policies, as in the case of our own provision for tax exemption of income earned abroad by citizens who are in foreign countries for 17 out of 18 months. But conversations with those concerned with tax policies in other countries often lead to the conclusions that differences in national policies regarding the taxation of international income exist simply because they happened to start the way they are when tax rates were much lower and have

continued along the same line until, at present high rates, any change of policy would lead to either a crushing new burden or an unduly generous windfall relief. But let us return to a review of the policies which may be adopted regarding the taxation of foreign income in the countries ultimately receiving it.

Those who advocate taxation of income only in the country of its source usually are the representatives of source countries with tax rates substantially lower than the countries of destination, if I may use the phrase, or those who receive income from such source countries. The arguments in favor of this position are stated in various ways. Sometimes it is claimed that there should be only one right to taxation of international income, and since the primary right belongs to the country in which the income is earned, the country in which it is received, by definition, has no right to tax. In this simplified version, the proposition is more of an assertion than a conclusion. In more refined forms, it is argued that if the source country is able to get along with lower taxes than those imposed in the country of destination, then the latter should not nullify the tax advantage which the source country is able to offer. An elaboration of this point is developed later in connection with the discussion of tax credits. A second reason advanced for taxing only at the source relates to the costs and benefits of government services, which it is argued are devoted to domestic affairs and do not extend to the foreign countries in which the income is earned; hence there is presumably no right to tax such income.

Against the argument of taxation only at source are the various positions which maintain some right of taxation by the country of destination. This right, as already noted, may be either primary, subordinate, or simultaneous. This position is based on a belief that citizenship, individual or corporate, carries with it an obligation to support the government financially, and that general tax burdens are not and cannot be related to particular benefits and costs.

The extreme position that a country of destination has a right to tax, with no recognition of any taxation in the country of source, would inevitably lead to multiple and discriminatory burdens on international income. Fortunately, this extreme position is seldom asserted. Countries of destination usually recognize the primary right to taxation by the country of source. When this recognition goes no further than an allowance of foreign income taxes as a deduction in computing net income subject to the domestic tax, there is still a differential adverse tax burden on international income. There is, again fortunately, I believe, an increasing practice of pushing the recognition of the primary right of taxation in the source country to the point of giving credit for the foreign income tax against the domestic income tax, either by statute or treaty agreements.

This practice, however achieved, gives assurance that international income, though it will be taxed in the aggregate at the higher of the two rates in source and destination countries, will not be discriminated against as compared to domestic income in whichever country has the higher rate of tax. This result seems to be a proper minimum objective of policy; anything short of it can be justified only if one is willing to discriminate against inter-

national income. Perhaps this position might be referred to as one of tax neutrality.

With any greater relief, there will be discrimination in favor of international income by either the country in which it is earned or the country in which it is received. In view of all the forms of domestic income for which special treatment is urged, it is understandable that special relief for income either received from or paid to another country is acceptable only when based on very good arguments. Numerous reasons are advanced as justification for favorable treatment through lower rates or a postponement of tax in the country of receipt.

A common reason given for such favorable treatment in the country of receipt is a presumption of greater risk in securing foreign income. This argument seems to be a weak one in view of the great range of risks in both foreign and domestic sources of income. Certainly there are many domestic activities that are more risky than a good many foreign ones. Stated in reverse, there are many sources of foreign income which are much safer than a good many domestic sources, and a general discrimination in favor of foreign income on grounds of risk would produce capricious results and windfall gains to those not subject to the higher risk. More fundamentally, adjustments in income tax rates to make them correspond to some extent to risk is rather difficult to justify in tax theory, and if adopted for foreign income it might also be expected to be applied to various sorts of domestic income, with extreme complications and uncertainties over time as relative risks appear to change.

A more substantial reason for differential treatment in favor of foreign income in the country where it is received arises from a desire to provide competitive tax equality with others in the foreign country where the income is earned. When taxes in the country of destination are higher than in the country of source, or in other countries of destination, these higher taxes become competitive disadvantages, to an extent that they are, or are regarded, as constituting part of the costs of carrying on an activity abroad. Thus a lower tax may be proposed on foreign income in the country of destination in order to facilitate business investment abroad on a competitive basis.

A third reason for differential tax treatment in favor of foreign income is to prevent the foreign countries of source from raising their own taxes to the level of rates in the country of destination. This possibility exists when tax discrimination against international income is avoided in the destination country by giving a credit of the lower foreign tax against the higher domestic tax. The temptation for foreign countries to absorb the full tax by making their own creditable taxes as high as those in the country of destination is a real one. In fact, it was at one time argued that our own system of crediting foreign taxes against domestic taxes had the good incidental effect of encouraging other countries to adopt high income tax rates. I have said before, and am glad to take this oportunity to repeat that this idea seems to me to be thoroughly wrong: our tax rate structure is nothing for us to encourage other countries to adopt. Rather, those countries which have been fortunate enough to maintain lower tax rates than our should be regarded as setting good

examples for us.

The fact that our credit for foreign taxes is sometimes an indirect encouragement for other countries to raise their own rates to ours is an unfortunate result of the credit system; it can be limited by strict control of creditable taxes, with disallowance of any special tax rates which are designed to affect only United States companies. With this policy enforced here, only income taxes of general application will be creditable, and appreciation of the bad effects of a generally high tax on a country's development should help to keep others from adopting our rates simply because they could get additional revenue from our companies without increasing the total tax burden of such companies.

The final and probably most basic reason for urging more favorable tax treatment of foreign income is simply that it can to some extent implement broad foreign policy objectives by encouraging private investment abroad and thereby foster economic development in other countries. The three preceding reasons are sometimes advanced independently and sometimes as supplements to this fourth general reason.

If a country chooses to give more favorable tax treatment to income from foreign sources than that given to domestic income, even though it does not adopt the principle of taxation only at source, the more favored treatment may be given by lower tax rates or a deferral of tax. The extent of rate differential, if one is established, cannot be set by any logical formula, unless it arises from an exemption of foreign income from some increase in tax rates which is thought to be temporary.

Postponement of taxation of income from foreign sources until it is brought into the country of ultimate destination, or until some other point in its transfer and use, is often advocated as an alternative or supplement to lower rates of tax on foreign income. It is most commonly proposed as a logical corollary to the tax treatment of foreign subsidiaries, the income of which is not taxed in this country until it is received by the domestic parent company. A similar postponement of taxation on foreign income earned abroad directly would make the tax laws neutral as regards the choice of form of organization. Such a tax policy would also be consistent with a national policy of encouraging investment abroad and would have the advantage of limiting the tax benefits to the period when foreign income is kept abroad and used there in one way or another.

The proposals for postponement of tax on foreign income must be appraised in comparison with the many comparable proposals which are and can be advanced for postponement of tax on domestic income of various sorts used in various ways. Many important forms of domestic investment would be encouraged by a postponement of tax on income used in appropriate ways. Special provisions for particular sorts of income are in a sense at the expense of and alternative to a general reduction in tax rates which is so greatly desired and needed. Proposals for new provisions must always be appraised in these terms.

The advantages of deferral of the domestic tax by the use of foreign subsidiaries is familiar to all who are active in international business. The use of a foreign subsidiary not only permits

the deferral of domestic tax, but the combination of a deduction and credit of the foreign tax will, at certain rates, give a lower aggregate tax than the domestic rate by itself. Our tax treatment of income received through foreign subsidiaries may properly be emphasized in meeting the arguments of critics, foreign and domestic, who say that this country gives no recognition to the special problems of foreign income.

Thus far, my comments have dealt only with what may be referred to as general principles concerning the relative rights and policies of the countries of source and destination to tax international income. As everyone familiar with actual problems in this area knows, there are many important and difficult problems in the definition of foreign and international income and in its allocation between countries where it may be deemed, under various concepts, to have a source in more than one country.

There is a temptation to believe that only broad concepts need be considered in establishing policy and that matters of definition can be left to technicians. But it is of no particular significance to agree that the country of source shall have a primary right to tax income, if this is followed by disagreement as to which country will be regarded as the source country or as to how the income is to be divided between two countries both of which are to some extent source countries. I cannot overemphasize the difficulties and great significance of differences in definitions; they have been at least partly responsible for long delays in treaty negotiations. With the best will in the world, they will continue to plague us. I should like to point out a few examples.

A problem of allocation always arises when products are made in one country and sold in another. How much of the net income is attributable to the production and how much to the distribution? May there be income attributable to purchasing? Though we do not regard mere purchasing for processing and sale outside a country as giving rise to income, some other countries with large exports of raw materials do. In trade activities, apart from production, where does income arise? Will some single criterion be established, as the place of passage of title or the situs of closing of the contract? And what will be done when apparently artificial arrangements with no business purpose are made to secure tax advantages? Are casual transactions to be treated in the same way as regularly established businesses, and what is meant by a regularly established business? What is to be considered the source of shipping, aircraft, and other income from transportation communications?

It is understandable that different countries may develop concepts and adopt definitions which attribute to them the maximum amounts of international income. The states in this country proceeded in much the same manner in attempting to secure the maximum base for taxing interstate income. And full reciprocity has by no means been achieved among them even now, though they are all part of a single national government. Recognition of these interstate problems should make us more tolerant of the international problems which stem from much greater differences in basic concepts, and more appreciative of the really great progress that has been made by statutes and treaties.

These same problems of definition

have been a major difficulty, I think it is fair to say, in the attempts to secure legislation in this country for differential tax treatment of business income from foreign investment. Short of a policy which would give the differential tax rates to all activities connected with goods destined for delivery abroad, there must be a line drawn somewhere to define foreign business income. A differential income tax based merely on foreign delivery constitutes, of course, an export subsidy which is unacceptable in international commercial relations. But any line short of such an export subsidy raises both administrative and competitive problems. Consider, for example, the problem of determining where straight export trade merges through an assembly operation into manufacturing. How much assembly or processing would be necessary to qualify for a differential tax rate? Consider also the special problems of particular industries, as for example, motion pictures. At what point does the addition of sound tracks, subtitles, or even the production of additional prints from a master film become production rather than ordinary export trade?

From the standpoint of competition, a lower tax rate is understandably resented by all those who do not benefit from it. Thus, a company with casual sales abroad will resent any advantage which is available to companies which operate on a scale that permits them to qualify for lower taxes on income deemed to be from foreign sources. Problems of definition, I repeat, are serious and difficult.

Problems of definition also arise in connection with a policy of allowing foreign income taxes as credits against domestic income taxes, which seems necessary to prevent discriminatory tax burdens against foreign income. It is unreasonable for the country of destination to expect the country of source to have altogether identical definition and concepts. Some latitude seems necessary if discriminatory burdens are to be avoided. But wide latitude in determining creditable taxes will make a farce of the whole process of tax credits, because it would ordinarily permit enough different foreign taxes to be added together to more than exceed the domestic income tax. If a policy of taxation only at source is to be adopted, it should be proposed and considered on its merits rather than achieved indirectly.

A special problem exists in connection with credits for foreign taxes when a foreign country temporarily waives some or all of its regular tax for a period of time for new companies or other activities which it desires to encourage. It is asserted that our tax system nullifies the tax advantages which other countries attempt to offer because the taxes which they forego, by reducing the tax credits which we allow, simply increase the tax in this country by the same amount. This criticism is greatly exaggerated; it is valid only when foreign operations are conducted directly rather than through foreign subsidiaries or through foreign subsidiaries from which all income is currently withdrawn. Where foreign subsidiaries are used the common expectation is that early earnings will be retained indefinitely and used for expansion. Typically the period of retention for expansion will equal or exceed the period of tax concessions, and when this is the fact, the foreign tax concessions are fully effective.

In recognition of the partial validity of the criticism about nullification of foreign tax concessions, this country is now in the process of trying to work out, as part of our tax treaty program, methods of giving credit for taxes foregone. Two sorts of problems exist in this attempt. First, it is necessary to be sure that the tax concessions are genuine and not merely nominal ones which have been created for the purpose of increasing a foreign tax credit and decreasing the net tax in this country, without any real concession from genuine foreign taxes that would otherwise really be imposed. Secondly, a decision has to be made on the cut-off date for recognition of credits. If the credit is given only for companies which receive concessions after the date of the treaty, these companies will have a competitive advantage over companies which receive tax concessions at an earlier date. Alternatively, if credit is given for all concessions outstanding, there will be windfall gains to companies which had no reason to expect credit against domestic taxes for foreign taxes foregone. Neither of these treatments is really satisfactory; a balance must be made between the disadvantages of each.

Tax treaties are admirably adapted to provide a means to reconcile and compromise differences in concepts and definitions. Without them, the best of intentions and principles may be frustrated. Consider, for example, a presumably simple situation where two countries both recognize the primary right of taxation to the country where income has its source and allow a credit against the domestic tax for the foreign tax paid on income from a foreign source. This basic agreement by no means assures relief from discriminatory multiple tax burdens on international income. If one country adopts the concept that income arises where production takes place and the other holds that it arises where the sale takes place, there would be full taxation in each country of income from international trade with no recognition in either of the tax paid in the other. Reciprocal agreements on the situs of taxation of various categories of income also provide certainty and convenience in important areas.

In some situations where relatively similar tax rates and concepts of income exist in several countries it may even be possible to look forward to multilateral tax agreements. More frequently, differences will be so great that only bilateral agreements can be expected to reflect all of the necessary reciprocal concessions necessary to minimize discriminatory tax burdens on international income. Fortunately, there is a good momentum in the direction of additional tax treaties.

In closing let me repeat the purpose underlying my remarks. I have not attempted to break new ground or argue for a particular policy. I have, rather, attempted to review systematically the principal proposals and problems in this very complex area. There is no aspect of taxation on which there are more diverse views than the one under discussion in this paper. When dealing with a subject of such complexity it seems helpful to make a periodic attempt to regain perspective by reexamining the full range of opinion.

THE ANTI-AVOIDANCE PROVISIONS OF THE LAW OF ESTATE DUTY IN THE UNITED KINGDOM

G. S. A. WHEATCROFT *

Introduction

THE provisions of most taxes can be divided into two parts; those which deal with the main subject matter at which the tax is aimed, and those which tax other transactions which, if not taxed, would give the taxpayer an easy way of lawfully avoiding the main provisions. The extent to which it is necessary to insert these secondary provisions in a taxing law is one of the tests by which a tax can be judged from an administrative point of view.

The object of this paper is to study the provisions of the law of Estate Duty in the United Kingdom and to see to what extent the original conception of the tax has had to be extended in order to prevent avoidance. "Avoidance" must be distinguished from "evasion". The former term covers those transactions which are lawful according to the letter of the law, but which enable the taxpayer to avoid paying part or all of the tax for which he would otherwise be liable. Evasion indicates transactions which are illegal and which depend for their success on the true facts being concealed from the taxing authority. Estate Duty is not easy to evade, owing to the obligation of executors and administrators to render full details to the Revenue of their deceased's assets and of all transactions entered into by him which may have incurred a liability to duty, and this paper is concerned solely with avoidance.

It is necessary to consider:— (1) the main principles of the tax as laid down by the legislature and interpreted by the courts; (2) the objects for which it was imposed; (3) the different types of transaction which have been or could be used to avoid the tax as it was originally planned; (4) the legislation which has been found necessary to bring those transactions within the taxing net; and (5) the state of the tax as it now stands and the extent to which avoidance is now practicable.

At the outset one important qualification must be stated. The law of estate duty is contained in some sixty different Acts of Parliament and a large number of decisions of the Courts. The leading textbooks on the subject run to over 1,000 pages. There are many minor exceptions and refinements to the general provisions of the law which cannot possibly be mentioned in the space of a paper of this kind. Hence the statements of law which follow must be treated as generalities and sub-

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ject to minor qualifications which are not always mentioned.

The Main Principles of Estate Duty

The main principles of Estate Duty are simple. The capital value of all property which " passes " (i.e., " changes hands ") as the result of the death of an individual is taxable. Clearly all property [1] which he owned at his death [2] " passes " to someone else, since he cannot take it with him, whatever his destination. In addition, all property which is settled [3] on trusts which result in an alteration of the beneficial interests in income before and after the death also passes.[4] The common case is when the deceased is life tenant and the trust fund is taxable on his death. If property is limited on trust to divide the income betwen *A*, *B* and *C* and the survivors for their lives, and then on trust for *D*, there will be a passing of one third of the fund when the first of *A*, *B* and *C* dies, of one half when the second dies, and of the whole when the last dies.

In considering the liability of tax it is immaterial whether the deceased was beneficially interested in the settled property, although this may be important on the question of aggregation;[5] if settled property " passes " on a death it is *prima facie* taxable. Thus, if property is limited to *A* for the life of *B* and then to *C*, there is a passing on the death of *B* of the whole of the property.[6] Similarly, if there is an accumulation during the life of *A*, followed by a life interest to *B*, there will be a passing on the deaths of both *A* and *B*.[7]

All the property which " passes " on a death, whether free or settled, is valued and aggregated together, and the rate of tax is calculated on a progressive scale according to the total value of all property passing, after deducting appropriate liabilities.[8] Hence, if *A* is a millionaire and is also life tenant of a small trust, the duty on the trust property will be extremely heavy, although the persons entitled to the trust on *A*'s death may not share at all in *A*'s free estate. Conversely, if *A* is tenant for life of a large trust, which he cannot dispose of, the rate of duty on his own estate may be entirely disproportionate.[9]

There is one main exception to the rule about aggregation, which provides that property in which the deceased never [10] had an interest is treated as a separate estate by itself and only pays duty at the rate appropriate to its own

[1] For Estate Duty purposes " property " includes both real and personal property and, in effect, means any asset of any value (see also note 14 *infra*).

[2] Excluding property, such as an annuity, which terminates on the death; this is taxable under another provision mentioned later.

[3] " Settled property " includes property limited for persons in succession whether by will, settlement or any trust arrangement and, in effect, means any property subject to trusts or rights which prevent one person having complete ownership.

[4] The cesser of an accumulation on a death does not of itself create a " passing " so long as the person who becomes entitled to the property or income after the death is also entitled to the accumulations of income before the death.

[5] See below.

[6] If *A* dies in the life of *B*, the right to the income during *B*'s life passes to *A*'s executor who must pay duty on *A*'s death on the actuarial value of that right.

[7] Cf. note 4 *supra*. Here *B* does not become entitled to the accumulations.

[8] For the special legislation regarding these, see later.

[9] There is an exemption for free estates under £10,000 from aggregation with settled property. F.A. 1954 s. 33.

[10] " Never " means " never at any time " and does not only refer to the deceased's interest at the time of death.

value.[11] Thus, if *A* by will leaves property to *B* for *C*'s life, the property, when passing on *C*'s death, is treated as a separate estate.

The rates of duty are highly progressive; they range from 1 per cent on estates beween £3,000 and £4,000 to 80 per cent on estates over £1 million. Typical intermediate examples are: 6 per cent between £10,000 - £12,500, 18 per cent between £25,000 - £30,000, 35 per cent between £50,000 - £60,000, and 50 percent between £100,000 - £150,000. It is important to notice that as an estate increases in value and so gets into a new and higher rate of duty, that rate applies to the whole estate and not only to the excess over the previous figure; but there is a provision to deal with "marginal estates" which are just over the figure at which a rate increases, so that the duty on these estates does not make them of less value than they would have been just under the figure.

Since 1946 there has been no duty on estates under £2,000 (£3,000 since 1954), so that the large majority of the 550,000 people who die each year in the United Kingdom are not affected by the tax. The Revenue statistics show between 70,000 and 80,000 new "estates" each year, and this figure is expected to drop to approximately 50,000 per annum when the estates between £2,000 and £3,000 cease to be recorded.

The steep progression in the rates results in the tax revenue (£180 million p.a.) being mainly provided by a small number of large estates. Over 70 per cent comes from the 2,000 odd estates each year exceeding £50,000, and over 25 per cent from the 120 odd estates exceeding £250,000.[12] A tax of this kind, which falls mainly on wealthy people and claims a high proportion of their wealth, is particularly vulnerable to avoidance devices; wealthy people can afford to pay for the best legal advice, and it clearly pays them—or rather their heirs—to do so.

The History and Objects of the Tax

The main object of the tax has always been the raising of revenue, and from an administrative point of view it is reasonably cheap and easy to collect, owing to the obligation of executors, administrators and trustees to supply the information on which assessments are made. The tax is also supported for social and economic reasons—particularly by Liberal and Socialist politicians—on the ground that it diminishes inherited wealth and encourages each new generation to create its own resources instead of living on the fortunes of its fathers.

Estate Duty was originally imposed by a Liberal Government in 1894 and was partly aimed at the great landowners. The maximum rate, however, was then only 8 per cent. The famous "Lloyd George" Budget of 1909-1910 put the rates up substantially (maximum 15 per cent), but the main increases in rates came in 1919 (maximum 40 per cent) and 1940-1946 (maximum 75 per cent) from the necessity of financing two world wars. The last increase in 1949 was due to administrative reasons. Until that date there were two other taxes on death, namely, legacy duty and succession duty, which taxed the actual benefits received by beneficiaries as a result of death at rates which varied accord-

[11] F.A. 1894 s. 4.

[12] *See* article "Sources of Estate Duty" in *The Times Review of Industry*, April 1956.

ing to the relationship of the beneficiary to the deceased. These taxes were abolished, however, in 1949, and an increase was made in the rates of Estate Duty to compensate the Revenue. The principle of lower rates for near relatives was not transferred to Estate Duty law, and at present the liability for Estate Duty is not affected by the relationship of the heirs to the deceased, except that settled property which has paid duty on the death of one party to a marriage does not usually pay duty on the death of the other party. There is also now no difference in the liability or extent of duty in the case of charitable gifts or settlements, except that charities do not die, so that once property reaches a charity it no longer pays duty.[13]

From the avoidance aspect it is probably fair to assume that little action will be taken by persons who expect to pay less than 10 per cent and that it is not until the prospective rate exceeds 30 per cent that very serious consideration will be given to means of avoidance. The following table shows what size of estate paid 10 per cent or more and 35 per cent or more over the years since the duty was imposed:

	Estates Which Paid 10 Per Cent or More	Estates Which Paid 35 Per Cent or More
1894–1907	none	none
1907–1909	over £750,000	none
1909–1914	over £150,000	none
1914–1919	over £100,000	none
1919–1925	over £ 40,000	over £1,000,000
1925–1930	over £ 25,000	do.
1930–1939	do.	over £ 300,000
1939–1940	do.	over £ 200,000
1940–1946	over £ 21,000	over £ 150,000
1946–1949	over £ 15,000	over £ 75,000
1949–to date	do.	over £ 45,000

This table shows why Estate Duty avoidance became a serious subject of study from 1930 onwards and is now part of the normal lawyer's practice.

Methods of Avoidance Covered by the Original Scheme of the Tax

From the early days of the tax it has been necessary to have a number of provisions to cover simple methods of avoidance. Thus property passing " on " a death includes property which passes at some date calculated in relation to a death.[14] If it were not for this provision, a trust arrangement could provide that the property passed (say) seven days after the relevant death and would thus escape the duty. " Property " was originally defined to include all real and personal property whether settled or not,[15] and this definition was later extended to include debts or rights enforceable against the deceased and the benefit caused by the relinquishment of such a debt or right.[16]

A number of types of property which do not actually " pass " on the death have also been charged to duty. The method adopted by the legislature is to " deem " various classes of property as " passing," although they in fact do not pass. Thus property which the deceased is competent to dispose of at his death, but does not dispose of, is taxed as though he had done so.[17] If the deceased has a general power of appointment over some trust fund (i.e., a power which would enable him to appoint to himself or his executors) and dies without exercising it, the property is chargeable to duty when he dies.

[13] There is also a reduction in the period before death for a charitable gift to escape duty on the donor's death (*see later*).

[14] F.A. 1894 s. 22(1)(e).

[15] F.A. 1894 s. 22(1)(f).

[16] F.A. 1940 s. 45.

[17] F.A. 1894 s. 2(1)(a).

But a special power of appointment (i.e., a power to appoint to one or more of a limited class of persons, such as "the children of X") does not give rise to any claim for duty under this head. Property held jointly by the deceased, which passes by survivorship on his death, is usually caught by this provision, as he could normally have severed the joint tenancy before he died.

There is a further provision dealt with later which catches those cases where the deceased had no right to dispose of his interest but originally provided the joint property. Interests in property which do not actually pass on the death but merely cease to exist, such as an annuity which ceases on the death, also give rise to a charge for duty on the capital of the fund which provides for that interest.[18] A further type of property included in the original scheme of the tax is an interest purchased or provided by the deceased which comes into existence on his death, such as an annuity which he has purchased for his wife which does not commence until he dies.[19] Such an annuity may, however, be exempt from aggregation on the ground the deceased never had an interest in it.

The original scheme of the tax thus not only included property which "changed hands" on the death but also covered (1) property which could have changed hands had the deceased so provided, (2) interests in property which came into existence on the death, having been provided by the deceased, and (3) interests in property which ceased on the death.

As thus extended there remained four main ways by which the tax could be avoided or diminished, and special legislation has been directed against each of them. They are: (1) gifts or settlements by the deceased before his death; (2) the creation of liabilities so as to reduce the value of the estate; (3) the use of life insurance policies; and (4) transactions with companies controlled by the deceased or his family. These each require separate consideration.

The Legislation Relating to Gifts and Settlements

Apart from the normal stamp duty (usually 2 per cent) on transfer of property, whether by sale or gift, there is no tax in the United Kingdom on gifts when they are made and, apart from special legislation, there would, therefore, be a simple way of avoiding estate duty by transferring property before the death occurred.

When Estate Duty was imposed in 1894, a former, somewhat similar duty on personal estate, known as Probate Duty, was repealed together with another duty known as Account Stamp Duty, which had been enacted as a corollary to Probate Duty and taxed property affected by certain types of transactions entered into by the deceased before he died. The provisions of Account Stamp Duty were, however, enlarged and included in the general law of Estate Duty,[20] with the result that this latter duty became chargeable on various types of property given or settled by the deceased.

Estate Duty thus was charged on: (1) property the subject of a *donatio mortis causa* (a gift in anticipation of

[18] F.A. 1894 s. 2(1)(b).

[19] F.A. 1894 s. 2(1)(d).

[20] For all these provisions *see* F.A. 1894 s. 2(1)(c) incorporating provisions of the Customs and Inland Revenue Acts 1881 and 1889.

and conditional on the subsequent death of the donor); (2) joint property provided by the deceased which passed on his death by survivorship; (3) settled property in which the settlor reserved a right to retain the property or some interest determinable on his death; and (4) any gift or voluntary settlement, except in consideration of marriage or of certain small amounts, unless made more than one year before the death, and *bona fide* possession and enjoyment was assumed by the donee or beneficiaries immediately upon the gift and thenceforth retained to the entire exclusion of the donor or of any benefit to him by contract or otherwise.

In considering whether there are reservations made by the settlor or benefits retained by him, the law only recognizes interests which could benefit the settlor financially. He may remain a trustee of a trust created by himself without thereby incurring duty on his death, so long as that office confers no financial benefit, and he can thus retain the power to vote the shares subject to the normal obligations of a trustee to use his powers only in the interests of the beneficiaries. He may also retain a special power of appointment amongst a named class of beneficiaries so long as such power cannot be used to benefit himself or his estate.

The period of one year was extended to three years by the Finance Act of 1910, except in the case of gifts for charitable or public purposes for which the original period of one year has always been retained. The three-year period was extended to five years by the Financial Act of 1946.

These provisions are normally adequate to catch any dispositions of property which are entered into in anticipation of an early death, but there are a large number of wealthy individuals who have reached an age when they are prepared to pass a part of their fortunes to their children but are still likely to live at least five years. A man aged 60 with a fortune of £500,000 runs no great risk of penury if he parts with half of his fortune and uses some of his remaining capital to supplement his income for the rest of his life. Such a transaction, if he lives five years, will not only free half his estate from duty but also reduce the rate on the remainder. No statistics are available of the extent to which this method is being adopted to save duty, but most lawyers in large practice will confirm that it is extensively used. Fortunately, for the Revenue, however, there are still a large number of wealthy men who are not prepared to part with their property before they die.

The method of imposing a tax at the date of death on property which the deceased has parted with some years, possibly many years, before raises one major problem: how is the value of that property to be determined, and what is to happen if it no longer exists?

The present law, as finally determined by the House of Lords in 1954, is that the property originally given or settled must be traced and valued as at the date of the deceased's death, even though it is no longer in possession of the donee or the trustee. Hence, if a man gives away some shares to his son, and the son sells the shares, but the father dies within five years, the duty which the son has to pay depends on the value of the shares at the date of death and not on the price which he got for them. A sale in these

circumstances is obviously a somewhat speculative transaction. As a result of this decision, an easy way of avoidance has been opened to those people who can give away something which is of value when they give it, but which shortly becomes of no value. A debenture or treasury bond which is about to be repaid shortly is particularly suitable for a gift of this nature. Once it has been repaid, the original debenture or bond is of no value (except as a piece of paper), and there is at present no provision in the law which entitles the Revenue to claim duty on the redemption money. Not unnaturally this method of avoidance is being widely practised, and it is probable that the law will be altered soon to enable duty to be charged in such cases on the property which has replaced the original gift. Such a provision is by no means easy to draft or enforce administratively; this is particularly true in cases where the deceased retains some interest in the property and the claim for duty arises many years after he parted with the property.

Before leaving the subject of settlements, one other common method of avoidance which is still open should be mentioned. By settling property for some lengthy period, e.g., 60 years, and giving the trustees discretionary powers to distribute the income, and often also the capital, among a large class of beneficiaries, there will be no " passing " of the property during the lifetime of the trust and so no liability to duty. A settlor must not retain any interest himself under the settlement and must live for five years, but if these conditions are satisfied, the income can be distributed among the settlor's wife, children, and remoter issue and their wives, as the trustees select, without any liability to duty on the deaths of beneficiaries as none of them has an enforceable legal interest. Such a settlement involves considerable confidence in the chosen trustees,[21] but provided they carry out the settlor's wishes, the family fortune may be retained intact notwithstanding frequent deaths. Here again some alteration in the law is not unlikely, so as to charge duty on the share of any settlement on which the deceased actually received the income in his lifetime, whether he was entitled to it or not.

Releases of Life Interests

Akin to gifts are releases of a life interest under a settlement before the death of the life in question. If *A* is the tenant for life under a settlement, those interested on his death can foresee a liability on his death which, if he is wealthy, may well be at a much higher rate than that appropriate to the settled property alone (i.e., owing to " aggregation "). The obvious way of avoiding the duty is to persuade the tenant for life (either voluntarily or for consideration) to release his interest before he dies, so that there will be no " passing " when he dies. This type of transaction has now also been brought within the taxing net, and if the original life tenant dies within five years after such a release, duty is payable on the settled funds,[22] and trustees are made responsible for retaining sufficient funds to answer for the prospective duty.[23]

21 In theory the settlor may himself be a trustee, or even sole trustee, but in practice this is rarely done, owing to the risk of a change in the law on this point.

22 F.A. 1940 s. 43 (enlarging previous legislation on the subject) and F.A. 1950 s. 43.

23 F.A. 1950 s. 44.

There is one loophole which is now much used. If a tenant for life purchases the interest of the remainder man for full value, so that he acquires the whole settled fund in return for the price he paid, these special provisions do not apply. Hence, where the tenant for life is elderly and the value of the remainder man's interest is high, the balance remaining in the tenant-for-life's hands at the end of the transaction, which will pay duty on his death if he does not spend it, will be much less than the value of the fund, which would otherwise have paid duty. This method cannot, however, be used where the remainder men are not all ascertained and *sui juris*, except with the assistance of the Chancery Court.

Such assistance also may be required for the release of a life interest when it is " protected ". The extent of the Court's jurisdiction in these cases and the occasions on which it will be exercised are gradually being ascertained by the decisions in a number of reported cases. The House of Lords has held that, if the transaction is one which falls within the Court's jurisdiction to approve, it may properly exercise that jurisdiction although the object of the transaction is to avoid duty.[24]

Liabilities Created by the Deceased

In calculating the assets of a dead man for duty purposes, it is obviously correct to deduct his debts, and the law so provides.[25] An obvious method of avoidance is to take advantage of this provision by creating debts in favour of children or other heirs which will not be enforced in the deceased's lifetime. Legislation has therefore been passed to disallow, for duty purposes, (1) debts created for less than full consideration (annuities to the deceased from relatives are not treated as " consideration")[26] (2) certain debts incurred for the purchase or extinction of an interest in expectancy,[27] and (3) debts for which the consideration was originally derived from the deceased[28] (e.g., if the deceased gave his son his house and then bought it back, leaving the price unpaid, that price would not be an admissable debt for duty purposes).

Hence, an insolvent estate may be liable for substantial Estate Duty (which is a charge on the assets before any debts are paid) if there are large debts which are disallowed for duty purposes.

Policies on the Life of the Deceased

A life insurance policy which is owned by the deceased when he dies is chargeable with duty on the amount payable under the policy, as it passes on his death. As the amount of the policy is aggregable with the rest of his estate, the existence of the policy may well increase the rate of duty and give little benefit to anyone, except the Revenue. If a man expecting to die worth £120,000, with prospective duty at 50 per cent, maintains a life policy for £60,000 with the thought that it will cover the duty, he will increase his estate to £180,000 and pay duty at 55 per cent (£99,000) with the result that the policy will only benefit his estate by £21,000. Actually it would be necessary for him to maintain a policy for £180,000, with prospective duty

[24] Chapman v. Chapman, 1954, A. C. 429.

[25] F.A. 1894 s. 7(1).

[26] F.A. 1940 s. 44 and F.A. 1950 s. 46.

[27] F.A. 1894 s. 7(1).

[28] F.A. 1939 s. 2(1)(c) and F. A. 1943 s. 26.

at 60 per cent (on £300,000), in order to keep his estate of £120,000 intact on his death, and present income taxation makes it impossible to find the premiums (although subject to some income tax relief) out of income.

One obvious way out is for the policy not to be owned by the deceased, but by his heirs, and the Legislature foresaw, even in the days of Account Stamp Duty, that a man might well give such a policy to his wife and continue paying the premiums. A special provision was therefore made, which was transferred to Estate Duty in 1894, by which duty is chargeable on a policy effected by the deceased and kept up by him for the benefit of the donee.[29] This liability has been extended to policies kept up under a settlement made by the deceased.[30]

Considerable avoidance of duty, however, may still be achieved by taking out a policy in such a way that the deceased never had any beneficial interest in it (e.g., in his wife's name under the Married Women's Property Act). If so, it comes under the exception to " aggregation " which excludes property in which the deceased never had an interest; such property is taxed as an estate " by itself ". If it is below the starting point of Estate Duty (£3,000) it pays no duty and, if larger, may still pay much less duty that if it formed part of the decedent's estate. This led to avoidance of duty by the simple means of taking out a large number of £1,000 policies. This was partially stopped in 1954 by a provision which groups all such policies according to the persons entitled to them.[31] The policies of each beneficiary are aggregated together, and the rate of duty depends on the total of each beneficiary's interest. Even so, a wealthy man can substantially avoid duty by taking out policies for his wife and children in which he never had any beneficial interest, so that on his death the policy moneys form separate " estates ", thus paying lower rates of duty themselves and not being included in his own estate when the rate on that is calculated.

There has been some conflict of judicial opinion on the question whether a policy which has been given away or settled " passes " on the settlor's death. It is now clear that a policy which the settlor has given outright to some person more than five years before his death escapes duty so long as he has not kept it up after the gift.[32] But if a policy is settled on terms which provide that on the maturity of the policy a new interest arises under the settlement, it may be treated as " passing " and so incurs duty.[33]

A policy which is given away or settled and is then surrendered before death occurs would appear to escape duty under the rule discussed before, by which an asset which has ceased to exist before the death cannot be valued for duty purposes.

Transactions with Companies Controlled by the Deceased or his Family

The private company, owned and controlled by one person and his immediate relatives, is a common feature in the United Kingdom; the attraction of limited liability has led the owners of

[29] F.A. 1894 s. 2(1)(c) and Customs & Inland Revenue Act 1889 s. 11.

[30] F.A. 1948 s. 76.

[31] F.A. 1954 s. 33.

[32] d'Avigdor-Goldsmith v. I.R.C. (1953) A.C. 347.

[33] re Barbour (1956) 2 W.L.R. 735.

most businesses of any size to transfer them to such companies. Such a company may also be used to hold the investment of a private individual or his family. The conception of a company as a separate juristic person from its members created considerable opportunities for avoidance of Estate Duty, and extensive legislation has been passed to deal with the more obvious methods.

Thus gifts by a company controlled by a deceased person are treated as gifts by the deceased to the extent of his interest in the company.[34] A special method of valuation of shares—based on the value of the company's assets rather than on the value of the shares —is also applied to such companies.[35] Transactions with a company controlled by not more than five persons and their families are treated for duty purposes as if they were transactions with relatives of the deceased if a relative is a member of the company;[36] certain transactions with relatives are less favourably treated for duty purposes than transactions with nonrelatives. A number of the normal defences to a claim for duty (such as purchase for full consideration, or a transfer over five years before death without any subsequent benefit to the deceased) do not apply if a company concerned is similarly controlled, and the defence would not be available if that company was treated as a trustee for its shareholders.[37]

There is also a set of extremely complicated provisions which render a company liable to Estate Duty when the deceased has received benefits from a company in excess of reasonable remuneration after he has transferred property to that company.[38] These are aimed at the man who sells his business to a company, gives away most of the shares to his family more than five years before his death but still takes the bulk of the profits as remuneration or by way of loans. In such cases duty is charged on the slice of the company's assets which corresponds to the benefit received by the deceased.

Despite all this legislation, transactions with private companies still offer opportunities for duty avoidance. One of the most commonly used is a gift of shares followed by a bonus issue (i.e., a stock dividend), as only the gifted shares attract duty and the bonus shares are free.[39] The flexibility with which voting rights can be attached to one class of shares, and dividend and capital rights to others is often of considerable assistance in creating situations where duty can be minimised or avoided, although the extremely wide, and often obscure, wording in which the legislation regarding Estate Duty on company transactions is framed makes the use of such devices extremely dangerous, except on expert legal advice.

Other Methods of Avoidance

Besides the main methods already discussed there are a number of other opportunities of minimising duty which are open to the well-advised person. Most of these take advantage of some special exemption in the Estate Duty law and utilise that exception in a way which goes far beyond the original purpose of the exemption.

34 F.A. 1940 s. 44(1)(c).

35 F.A. 1940 s. 55 and F.A. 1954 ss. 29 & 30.

36 F.A. 1940 s. 44(4).

37 F.A. 1950 s. 56.

38 F.A. 1940 ss. 46, et seq.

39 A. G. v. Oldham (1940) 2 K.B. 485.

Thus the Legislature has provided for a substantial reduction (45 per cent) in duty on agricultural land, and many people shortly before their death become purchasers of this type of property, which the heirs resell after the death occurs. Specially favourable duty treatment is accorded to owners of growing timber and works of art of national importance; both types of assets now figure prominently in the estates of those avoiding duty. Certain Government bonds are free of duty when held by someone resident and domiciled abroad; they can conveniently be held by a family company incorporated under another taxation jurisdiction (e.g., the Channel Isles). It also appears that a gift of one of those stocks, which is then quickly sold to some foreign owner, also escapes duty so long as the foreigner still holds it when the death occurs.

Most wealthy men have interests of various kinds which, in one way or another, can be utilised to take advantage of some favourable provision of the law, and there is no doubt that some method of substantially reducing duty liability is open to nearly every person of wealth.

Conclusion

The reader may well be forgiven for wondering how, in these circumstances, as much as £180 million is collected annually from this tax. How much could be collected if the many loopholes were stopped is a matter of guesswork. Presumably the Revenue authorities do not believe the sum to be large. Most of the methods of avoidance outlined here have been well-known for years to those who specialise in this subject, and little new anti-avoidance legislation has been passed in recent years. Clearly many wealthy people are not much interested in saving their property intact for their heirs, and those that attempt avoidance always run the risk of further legislation being passed before they die which will nullify their elaborate schemes. Only those who expect to die in the current tax year can confidently rely on successfully avoiding duty.

There is, however, not much doubt that the law of Estate Duty is in need of a thorough overhaul. When that is done, it may well be found that there is no practical way of dealing with voluntary transactions before death, except by taxing them when they occur—i.e., a gift tax which, when paid, will confer exemption from duty on the subsequent death of the donor. I gather, however, that in the United States the gift tax has raised many difficult problems, and possibly some compromise between the two systems might be appropriate for both countries.

INTERCOUNTY EQUALIZATION IN CALIFORNIA

Part 1: The Mechanics

RONALD B. WELCH *

IF this article had been written a year ago, its title might have been bowdlerized, in a style popular at the turn of the century, as "I———y E———n in California." Intercounty equalization was an impolite term in California in April 1956, as taxpayers in 13 counties were paying the second installments of their 1955-1956 property taxes on assessments which were anywhere from 19 to 39 per cent higher than they would have been in the absence of such equalization, while taxpayers in a fourteenth county were gloating over a court victory which was popularly (but erroneously, in the writer's opinion) believed to have discredited all the 1955 intercounty equalization orders of the State Board of Equalization.

Today things are different. After issuing 14 orders in 1955, the State Board was able to use moral suasion in 1956 as the main tool to accomplish its purpose of gradually reducing the disparities in average county assessment levels which had developed during 18 years in which no orders had been issued and few had even been considered. After the 1956 equalization period had passed with the issuance of a single order by the Board, an accord was reached with the county assessors, and a program which is novel in several respects is to be put to the test in the 1957 equalization period. Whether the pleasant honeymoon which is drawing to a close presages a happy marriage remains to be seen, but the wedding party is hopeful.

The 1949 Law

The current era in California intercounty equalization, which begins in 1949, has been distinctive in a number of respects. For one thing, the California Revenue and Taxation Code contains an intercounty equalization law which, though eight years old, has never been put into operation. Early readers of this *Journal* may recall an article by Professors Davisson and Schmelzle which described this 1949 law.[1] Several provisions of the law are worthy of repetition here.

Probably the most unusual feature of the law was its combination of what are known in California as the "uniform-ratio" and the "variable-ratio" methods of equalization. By the uniform-ratio method is meant the equalization process which seeks to bring to a uniform level the ratio of total assessed value to total market value of taxable

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[1] Malcolm M. Davisson and William K. Schmelzle, "Equalization of Property Tax Assessments in California," *National Tax Journal*, September 1950, pp. 221-232.

property in each county.[2] The variable-ratio method, on the other hand, is a means of achieving the ends of equalization without changing assessed values; its purpose is to make the assessment level of a county a matter of indifference to both the county and the state by adjusting state property tax rates, state equalization grants, local tax rate limits, and the like to whatever assessment level is achieved in a given district.

The 1949 California law permitted the use of only the variable-ratio method in a county whose average assessment level was found to be within 10 per cent of the state-wide average level and limited its use under these circumstances to one of the purposes served by intercounty equalization—equalization of state- and locally-assessed property values.[3] When a county's assessment level was found to be more than 10 per cent above or below the state-wide average, however, the State Board of Equalization was given its choice of leaving assessed values unchanged, on the one hand, or, on the other hand, of raising or lowering all assessed values on the county's local roll by whatever uniform percentage amount was required to bring the county-wide average level to the state-wide average level.

Another distinctive feature of the 1949 law was its use of the state-wide average assessment level rather than full value or some fraction of full value selected by the State Legislature as the target toward which equalization actions were to be directed. In effect, the State Legislature delegated the duty of setting the assessment standard to another group of elected officials—the 58 county assessors—each of whom was to have as many votes as he had dollars of locally-assessed value in his county. Whether this delegation was appropriate in a state in which one county contains 40 per cent of the assessed value and another less than 1/100 of 1 per cent is an interesting question but one which has become academic in the light of subsequent events.

Objections to the 1949 Law

Although the 1949 law passed both houses of the Legislature without a dissenting vote, opposition to the law became articulate before it was scheduled to be put into use. The major objections were of two types.

There was objection by local officials to the required disclosure of average assessment ratios in the several counties on the ground that this would encourage an excessive number of appeals to local boards of equalization by those who had previously been satisfied with their assessed values but now thought that they were assessed at higher-than-average levels. It was also feared that publication of the averages would be an

[2] If townships or other jurisdictions smaller than counties serve as assessment districts, either the state equalization agency or a county equalization agency commonly uses the uniform-ratio method to bring the ratio of each such district to a common level. Also, if the equalization agency has the authority to raise or lower the assessed values of different classes of property within an assessment district (e.g., real property and personal property), or of all properties in different parts of the district (e.g., inside cities and outside cities), by different percentage amounts to bring the ratios for each to a common level, it exercises this authority by use of the uniform-ratio method.

[3] This equalization is required by the Constitution. The other purposes of intercounty equalization in California are equalization of state aid for school operations, school construction, care of crippled children, and (in the event of a Governor-declared emergency) unemployment or indigent relief; equalization of tax and debt limits of local governments; equalization of property-ownership qualifications for old age assistance, blind assistance, assistance to needy children, and veterans' exemptions; and equalization of the amount of property to which the veterans' exemption applies if veterans qualify.

open invitation to " tax sharks " to solicit the accounts of discontented taxpayers, appeal their assessments, and collect as a fee a substantial part of any tax reductions which ensue.

The second major objection came from both local officials and locally-assessed taxpayers. It was feared that the 1949 law would result in substantial reductions in state-assessed property values and hence in a shift of tax burdens from state-assessed utilities to locally-assessed home owners, farmers, and businessmen. The law contemplated that these state-assessed values would be automatically scaled to the assessment level found for locally-assessed property in the county in which the state-assessed property was taxable. The State Board's Valuation Division, which appraises state-assessed properties, has attempted since its formation in the mid-thirties to appraise at full value, and the Board has consistently divided the staff's appraised values in half in preparing the assessment roll. Although 50 per cent was the traditional assessment level for county assessments, those who were familiar with assessment practices were well aware of the fact that the average assessment level for locally-assessed property had dropped substantially below this figure and were therefore apprehensive of the effects of the law.

Reinstatement of the Pre-1949 Law

By 1951, these objections and others much less rational had become so widely voiced that the Legislature voted to suspend operation of the 1949 law for two years, with the two-thirds majority in both houses required to give effect to the suspending legislation upon signature by the Governor. On July 16, 1951, the State Board of Equalization was required by the terms of the 1949 law to report its findings as to the ratio of assessed value to market value of property in each county. That day the suspending legislation lay unsigned on the Governor's desk. As the day waned, the Board obeyed the mandate of the 1949 law. A few minutes later, Governor Warren signed the bill. Thus, although the Governor had forced publication of the ratios by delaying his signature, the action which was supposed to flow from the ratio findings was caught in suspended animation.

The advice of the Attorney General was immediately sought, and it was opined that suspension of the 1949 law reinstated the pre-1949 statute law. This law added very little adornment to the blunt constitutional authority of the Board " to increase or lower the entire assessment roll . . . so as to . . . make the assessment conform to the true value in money of the property contained in said roll. . ." [4] Since the Constitution clearly contemplated use of the uniform-ratio method of equalization and there was no operative statute law obviating equalization by this method, the Board had a Hobson's choice. It could adhere to the policy of inaction which had been in vogue since 1938, a position that had been made uncomfortable by the accumulation of facts on which to predicate action under the 1949 law. Or it could act upon those facts by raising and/or lowering county assessment rolls by whatever percentage amounts were required to bring average county assessment levels to a common plane, with the painful repercussions that prior Board members had observed in 1935, 1936, and 1937. The Board chose the first horn of this dilemma, justifying the choice on the

[4] *California Constitution*, Art. XIII, Sec. 9. See Wells Fargo & Co. *v.* State Board of Equalization, 56 Cal. 194.

ground that the Legislature had appropriated so much less than had been requested for intercounty equalization work that the evidence on which action would have to be based was too limited.

It would take more space than is here available to recite in detail the subsequent course of events leading up to the action taken in 1955. Suffice it to say that after a Senate Interim Committee report of 1953 which recognized the need for intercounty equalization and the inadequacy of the pre-1949 law,[5] the appropriation for the Assessment Standards Division of the State Board of Equalization was increased modestly for the 1953-1954 fiscal year and substantially for the 1954-1955 fiscal year. Meanwhile, the operative date of the 1949 law had been postponed until 1955 at the 1953 legislative session, and until 1957 at the 1955 session, with urgency clauses in both bills which made them immediately effective upon receiving the Governor's blessings. Thus, when the Board prepared to act upon the findings of its staff in 1955, it had only the uniform-ratio method of equalization at its disposal.

The Value Evidence

Although the 1949 law had directed the Board to determine assessment levels by reference to " sales and other appraisal data," legislative leaders had made it clear as early as 1950 that they did not consider sales prices, even when supplemented by appraisals for property classes in which sales were infrequent, reliable evidence of market values. Since these leaders were influential in appropriation matters, it was concluded at an early date that the sampling of properties for assessment-ratio findings would be made without reference to property transfer records and that appraisals instead of sales prices would be used as the market-value estimates.

The choice of this method was supported in different quarters for different reasons. Most of its proponents probably believed that many if not all sales prices exceeded " full cash value," the statutory standard, and that appraised values would produce higher findings as to assessment levels than sales prices. This would minimize or prevent the shift of taxes from state-assessed to locally-assessed properties and would preserve taxpayers' illusions that their properties were assessed at less than the county-wide average. In other quarters appraised values were preferred to sales prices because their use would permit scientific sampling of local assessment rolls. When sales prices are used as the sole test of the assessment level, the only properties for which an assessment level is found are those that have been sold during the period covered by the sales data. The inference that the finding for this group of properties is applicable to properties that have not been sold within this period may be a plausible one, but it is one which must be accepted on faith. Use of appraisals calls for faith of a different order.

The preference for appraised values as the figures with which to compare assessed values was as appropriate for the uniform-ratio approach as for the variable-ratio approach. Thus the survey to be made for the 1955 equalization process was unaffected by the fate of the 1949 law at the 1955 legislative session, a fate which was not known until the survey was nearing completion.

[5] Senate Interim Committee on State and Local Taxation, *Property Assessments and Equalization in California*, March 1953, p. xix.

The Sampling Plan

Early in 1954, the Board constituted an advisory committee to suggest a sampling plan. This committee was comprised of members of the staff of the Senate Interim Committee on State and Local Taxation who participated in the 1953 study of the intercounty equalization problem and members of the Board's own staff. All members of the committee were in complete accord with the Senate Interim Committee's recommendation "that the annual sampling operations conform to the requirements of the principle of random stratified sampling and that the agency to which these tasks are assigned set up a system of sampling controls that will assure this result." [6] The first question raised, therefore, was the basis for stratification.

In stratification, it is the objective of the statistician to divide a universe that is nonhomogeneous with respect to the characteristic which is being measured into several strata which are relatively homogeneous with respect to this characteristic. If, for example, one part of an assessment district is assessed on the basis of appraisals made by one deputy assessor and the balance of the district on the basis of appraisals made by another deputy, the sample used to estimate the assessment level might be stratified geographically on the hypothesis that the two deputies had different concepts of value. The committee concluded that, in addition to geographical stratification, consideration should be given to stratification by property use, property value, and age of improvements (if any).

In order to use a stratified sample, one must be able to stratify the universe—that is, divide the universe into the several strata. In the problem at hand, this meant dividing the total assessed value of a county into several parts—for example, those parts which belonged in each of several geographical strata. This necessity quickly ruled out age of improvement as a basis for stratification, since it would have been utterly impossible to ascertain what part of the assessed value of a county related to properties whose improvements were of given ages. Property use was given up for the same reason, though more hesitantly because there was the possibility of stratifying on this basis the universes of counties with good appraisal records. But because California assessment rolls carry no property-use information, this course of action would have been expensive even where complete appraisal records were to be found and prohibitively costly where such records were incomplete or nonexistent. Geographical stratification would have been very easy and inexpensive since properties are grouped on the assessment rolls by tax rate area—the area within which a unique combination of tax rates (county, city, school district, etc.) applies—and assessed values are totaled for each such area. Area stratification did not appeal to the committee, however, because the available areas would not be likely to coincide with deputy assignments even where a geographical division of labor was employed in the assessor's office and because high-value properties, while contributing heavily to total assessed value, might easily be excluded from a small percentage sample in a given area. Value stratification, on the other hand, appealed strongly to the committee because almost every as-

[6] Op. cit., p. xx. The committee did not concur, however, with the recommendation that such "annual surveys should include at least one-half of 1 per cent of the number of parcels in each county . . ."

sessment-ratio study that has been made has shown variations in different value classes and because a considerable degree of property-use stratification is achieved by dividing assessments into different value groups.

Having made this basic decision, the committee spelled out a sampling plan in considerable detail. The plan was presented to the Board at a meeting in which assessors and other representatives of local government participated, and the Board held two public hearings at which criticisms of the plan were invited but none was offered.

The Stratification Process

Stratification by *value* meant stratification by *assessed* value, of course, since this was the only kind of value which was available for all properties. It was accomplished by going through a county's assessment roll, tallying real properties in different assessed-value classes on specially designed tally sheets,[7] tallying personal properties in a second run through the roll, and tabulating the assessed value of every *nth* property in a given low-value stratum and the assessed value of every property in the high-value strata. Nine different assessed-value strata, ranging from under \$1000 to \$1,000,000 and over, were used for real property, and the same nine strata were used for personal property.[8] By tabulating every assessed value over relatively low amounts in small counties and tallying low-value properties only on sample roll pages in large counties, a highly accurate stratification was achieved at little cost.

Selection of Real Property Samples

The assessed values which were tabulated in the stratification process provided the reservoir out of which sample properties were drawn for appraisal purposes. The real property sample for a given county was distributed among the several strata in a manner designed to minimize the error of estimate, using a standard mathematical formula that took cognizance of the relative importance of the several strata in the total assessed value of the county, the relative cost of appraisals in different strata, and the number of properties in each stratum.[9] The size of the real property sample in each county was computed with the purpose of obtaining as accurate an estimate of the assessment level in Alpine County (population 300) as in Los Angeles County (population over 5,000,000).

Ideally, one would have known the amount of variance within each stratum and the average assessment level in each county before computing sample sizes. Lacking such measures, one might have been expected to take a small sample in each county for the purpose of testing the variance and then enlarge the samples in varying degrees to provide the richest samples where variances were the greatest. This sequential sampling, however, would have been prohibitively costly because it would have required

[7] Except that the number of properties in the bottom stratum was determined residually by subtracting the number of other properties from the total number on the roll. Tallying was also unnecessary in the upper strata because every assessed value in these strata was tabulated.

[8] In addition to these 18 strata, developed petroleum mineral rights constituted a separate stratum for reasons that need not be recited here.

[9] In many of the smaller counties, there were very few properties in the higher strata. To avoid bias every one of these properties would have had to be appraised if the higher strata had not been merged. Staff limitations precluded such heavy sampling of the high-value properties, so a rule was adopted which provided for merging of strata containing fewer than 100 properties in any county.

that the appraisers revisit every part of the State, including many remote areas. The committee concluded, therefore, that these variables should be omitted from the formula used to compute sample sizes and distributions.[10]

After the approximate number of properties to be appraised in a county had been decided, random selections were made from among the assessments that had been tabulated when the assessment rolls were stratified. These assessments had been grouped by strata and arranged in assessment-roll order within a stratum. Thus the sample within a stratum was representative as to property use, age of improvements, location, and other characteristics.

The selections were made in a manner which absolutely precluded preference for one property over another within the same stratum, with no knowledge of the identity of the property other than a reference number by which it could be located on the assessment roll. That the choice of properties was blind is well illustrated by the fact that one of the properties selected turned out to be on an island accessible only by boat; another was on an almost inaccessible mountain top; and two were the plants of one of California's most powerful newspaper chains. Some substitutions were necessary because of inaccessibility of records, changes which the property was undergoing that made its value on the forthcoming assessment date too doubtful to justify prediction, and other reasons, but the substitutions were made in such a way that the randomness of the sample was only slightly disturbed by these changes.

To the best of the writer's knowledge, this was the first attempt to determine the real property assessment level in an assessment district for intercounty equalization purposes by random sampling of the whole assessment roll.

Personal Property Sampling

Tangible personal property sampling [11]—a blind spot in the ratio studies of most states that compare sales prices with assessed values to determine assessment levels—was a harder problem. Perhaps the greatest difficulty encountered here is that of ascertaining exactly what property was (or is to be) included in the assessment so that the same property can be appraised—a difficulty that is minimized in the case of real property by the necessity of precisely describing the land on the tax roll. When the appraisal is made before the assessment date, this is an especially difficult matter because the personal property that will be assessed may, at the time the appraisal is made, be nonexistent or in different ownership.

In view of these and other limitations inherent in the sampling of personal property, it was concluded by the advisory committee that a separate random sampling of personal property would not be worth what it would cost. Instead, it was the committee's recommendation that the personal property sample consist of personalty located on the real properties in the sample.

Had personal property holdings been randomly selected, only a few of them would have been located on real properties that were to be appraised. Hence,

[10] The theory of sample distribution with a stratified universe is well developed in Deming, *Some Theory of Sampling* (New York: John Wiley & Sons, 1950), Chap. 6, and Hansen, Hurwitz, and Madow, *Sample Survey Methods and Theory* (New York: John Wiley & Sons, 1953), Chap. 5.

[11] California tax laws apply to very little intangible property, and such property is excepted from the intercounty equalization process by law.

those appraising farm and residential properties would have had to make additional stops and consume valuable time gaining entrance to additional premises. Commercial and industrial personal property holdings were usually appraised by persons specializing in this type of appraisal, so separate visits for real and personal property appraising usually were required even though the personal property was located on the real property. Here, however, there was often a problem of distinguishing fixtures from personalty. If the assessor listed fixtures as personal property while the Board's appraisers, not knowing of the assessor's action, treated them as real property, the distortion of the data would be minimized, it was felt, by including both the real and the personal property in the sample.

Admittedly, this was a difficult choice. The opportunity to make a more truly random sampling of personal property and to appraise the selected properties has been much improved by a new technique introduced in late 1956 which is described below, and the question of personal property sample selection may well be reopened in the near future.

The Appraisals and the Ratio Computation

The major part of the job—the appraisal of the selected properties—needs little description here. Each property was valued with the use of standard appraisal forms and procedures by a staff ranging from 50 to 60 in number. In all, 9,000 real property appraisals and 4,000 personal property appraisals were made within the eleven months that were available for the 1955 survey.

When the appraisals had been completed, the market value of the sample for each stratum was then expanded in the proportion that the assessed value of the sample bore to the total assessed value of the stratum to derive the estimated market value of all properties in the stratum. The sum of the market values of all strata divided into the total assessed value of the county then produced the assessment ratio for the county.[12]

The Disclosure Problem

Although most of the recommendations of the advisory committee worked well in practice, there were numerous small unforeseen problems and a few larger ones. Perhaps the most troublesome problem was a feeling among many assessors that they should be apprised of the identities of properties in the samples. Insistence upon this disclosure was so strong that the State Board yielded to it despite a conviction that this tended to bias the sample. Most assessors felt that there was no danger of bias, that refusal to disclose these facts evidenced mistrust, and that they would be unable to develop an adequate defense against the findings of the Board's staff without knowing the properties in the sample long in advance of the Board's public hearings on their assessment levels.

Although the reasons for disclosure of property identities appeared to outweigh the arguments against it, the same could not be said of a later and much less widespread demand for foreknowledge of the appraised values ascribed to the sample properties by the Board's staff. Many of the assessors recognized that such a disclosure would destroy all

[12] The final ratio for a county is a weighted average of the strata ratios in which aggregate market values of the respective strata serve as weights. Incorrect answers result from the use of aggregate assessed values of the strata as weights as is sometimes done.

vestiges of validity of the Board's findings, and they joined with the Board in the development of a new procedure which dispelled the whole disclosure problem.

A New Approach

In the 1955 survey, appraisals made between August 1, 1954 and June 30, 1955 were compared with assessed values that were not set beyond recall until July 5, 1955. Thus most of the appraisals were completed before the assessments with which they were to be compared had been completed. The objections to disclosure with this scheduling are obvious, yet there were good reasons why disclosure was demanded. The solution to this dilemma which the experience of other states suggested was to compare the appraised values with assessed values that appeared on the prior-year roll instead of the current-year roll. This made full disclosure of the identities and appraised values of properties in the sample perfectly proper and eased several other problems, especially in the sampling of personal property.

But it created a new problem. California tax law, unlike the laws of some other states, contemplates that property will be revalued every year, so the assessed value of a county in one year can differ greatly from the assessed value the next year even if the county is undergoing little economic change. Moreover, some California counties are growing at a phenomenal pace so that new improvements and new subdivisions alone add from 5 to 15 per cent to the market value of locally-assessable property in a single year, while the locally-assessable properties of other counties are losing value or barely holding their own. Thus it is impossible to tell from, say, a 10 per cent increase in a county's assessed value during a year in which the general price level has remained relatively stable whether the assessment level has increased, decreased, or remained unchanged.

Comparison of the market value of locally-assessable property on the prior-year assessment roll with the assessed value on the *current-year* roll—the roll which is to be equalized with that of other counties—would be justified only if no change in the market value had occurred. To do this in all counties would produce exaggerated assessment ratios for the fast-growing counties and thus divert to them state aid that should rightfully go to other counties. Comparison of the market value of locally-assessable property on the prior-year assessment roll with the assessed value on the same roll and acceptance of the resulting ratio as the current-year assessment ratio would be justified only if one had the means of assuring himself that assessed values had exactly kept pace with market values—a very unlikely thing when the assessor was in the process of revaluing the county, as many California assessors are in any given year. It is therefore necessary, if appraised values are to be compared with prior assessments as the first step in the equalization of current assessment rolls, to update the estimate of total market value of locally-assessable property on the prior-year roll by one year and compare this up-dated estimate with the total assessed value on the current-year roll. This, the Board believes, can be done by reference to economic indices such as population, taxable retail sales, motor vehicle registrations, and the like.

Some who have heard this new procedure described only in general terms

have gained the impression that the market value of the sample rather than the market value of the universe will be updated. If the properties that had been appraised were ascribed a new aggregate market value and this new aggregate were to be compared with the aggregate assessed value of the same properties on the current-year roll, the disclosure problem would be intensified rather than cured. Moreover, if this were the procedure, taxpayers whose properties were selected for the sample might fear that their assessed values would be increased in order to obtain a favorable assessment-ratio finding (hence more state aid) for the county. When the total market value of property on the preceding local assessment roll is updated for comparison with the total assessed value on the current-year roll, the assessment-level findings are scarcely affected by changes that are confined to the small number of properties in the sample.

It is also now contemplated that sampling will be done over a cycle of two to four years instead of annually. It is planned to sample Los Angeles County every year because of its predominant influence on the state-wide average assessment level but to sample other counties at less frequent intervals. If, for example, a three-year cycle is settled upon, some 19 counties in addition to Los Angeles will be sampled each year. For these 20 counties, a one-year projection of the market value findings will be required. For another 19 counties, the projection will be for two years, and for the remaining 19 counties, three years. It is the present thought that intercounty equalization orders raising or lowering assessed values will be issued only on the strength of the one-year projections. If a two-year projection indicates that a county's assessment level has risen or fallen beyond the bounds of a reasonable tolerance zone, it is the intention not to issue an equalization order, but rather to make sample appraisals in the county in the next year although the county would normally not have been sampled until the following year. A three-year projection will not be used as the basis for an order, but if the ratio derived by such a projection for a given county falls squarely in the middle of the tolerance zone, the sampling of property in this county may be delayed until the fourth year in order to provide staff for sampling a county whose ratio indicates the need for a two-year cycle. Thus, normally, a county would be eligible for an equalization order only once in a three-year cycle [13] but would not be allowed to remain substantially out of line for two successive years.[14]

To be Continued

This in broad outline is the methodology that was used in the 1955 California survey and the changes which are in the making for the 1957 survey. A subsequent installment of this article will review the public hearings that preceded the 1955 orders to which reference was made at the opening of this installment, the effects which these orders had, and the public reaction to them.

[13] Los Angeles County, although sampled annually, would never be in danger of an equalization order since it has such a great influence on the state-wide average that it cannot conceivably have a ratio that differs much from that average.

[14] If a county were to effect a drastic change in its assessment level—a remote possibility—in a year for which a two- or three-year projection of market value was required, an equalization order may be necessary, however. In other words, two different tolerance zones may be required—an inner zone in which the county's ratio is fully acceptable and an outer zone in which scheduling for an appraisal survey in the following year is indicated. An assessment ratio which was not within either tolerance zone may require immediate correction.

STATE-LOCAL FISCAL POLICY AND ECONOMIC GROWTH

WILLIAM D. ROSS *

THE "economic growth" theme of the 1955 program of the annual meeting of the American Economic Association signified a complete cycle in the emphasis of economics. This cycle has occurred both in the literature of economics and in the interest of economists within the capitalistic nations of the world. Beginning with Adam Smith's analysis of "the wealth of nations" assumptions of full employment and consideration of potentialities for the ever expanding wealth of nations occupied the attention of economists and dominated the literature of economics. This continued to be the case until the Great Depression. The latter event ushered in a period of more than twenty-five years during which the watchword of economics has been depression and preoccupation has been with the problems of economic stability.

The capitalistic system faltered and almost collapsed in this country and throughout the world in the period from 1929 through 1934. Recuperation between 1935 and 1941 was slow and incomplete in the United States, and in the rest of the world even though war had intervened in Europe in 1939; large scale unemployment and unused productive capacity remained.

With the advent of World War II and with the mobilization of millions of young Americans into the armed services, unemployment and unused productive capacity quickly disappeared, followed by man power and production shortages of all types. War-stimulated expansion in the economy was spectacular. Despite this war-born prosperity, economists, business leaders, and government officials, almost without exception, anticipated and unhesitatingly predicted that the end of the war would bring business recession, threat of depression, and a problem of serious unemployment for secular as well as short-term reconversion reasons. Of course, nothing like this happened, and the embarrassed economic prophets offered various explanations as to why the stay of execution had occurred. Still there was no suggestion that the blow would not come. The potentialities of monetary and fiscal policy for containing the blow when it did come held the center of attention. Great progress was made during this period in getting virtually all occupational and political groups in the economy to accept the fiscal policy approach to the problem of economic stability. The Keynesian conquest became complete, as clearly evidenced by the policies of the current Republican administration.

Ironically, this conquest may have occurred at precisely the moment at which Keynes' specific concepts and analyses ceased to be applicable. Keynes, himself, may have presupposed this de-

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velopment by his comments, made shortly before his death, to the effect that inflation might well become a more serious problem for the modern capitalistic nation than deflation and depression. Perhaps no other economist has ever been more aware of the relevance of time and circumstances to economics. It has been suggested by some, however, that he referred primarily to the danger of price-wage spirals growing out of the monopoly power of organized labor and corporate enterprise, rather than to more fundamental changes in the economy that appear to have occurred.

In any case, the cycle in emphasis from economic growth to economic stability and back to economic growth was completed, at least nominally, by the papers presented at the sixty-eighth annual meeting of the American Economic Association. Careful examination of those papers will, nevertheless, reveal a continuing preoccupation with economic stability and an overwhelming emphasis on the means and possibilities of successfully combating recession.[1] In overview these papers cautiously suggest that serious unemployment and the other problems of instability associated with recession and depression can be avoided, and economic growth can occur. This certainly is a first step in understanding and analyzing the transformation that is occurring within our economic system. It is the thesis of this paper, however, that we have not yet begun to grasp the policy implications of the new features of the new and evolving economic system in which we live. This paper reviews briefly the development of fiscal policy concepts as applied to state and local finance in this country and then suggests some implications of some of the more important and explosive new elements in our economy for fiscal policy at all levels of government, but primarily at the state and local levels.

State-Local Counter-cyclical Fiscal Policy[2]

There is general agreement among economists that state and local tax, debt and expenditure policies must be coordinated with federal policies if maximum effectiveness is to be realized from any national program of counter-cyclical fiscal action. This is one of the lessons of the recent depression.[3] Although there is evidence that the negative effects of state and local fiscal practices during the period from 1929 to 1940 were not nearly so great as generally supposed, especially in selected states, some of the counter-cyclical effect of net increases in federal spending was offset by decreases in state and local expenditures.[4]

Economists do not agree as to the feasibility of a positive counter-cyclical role for state and local fiscal policy such as that suggested by the subheading of this Section.[5] Several studies have suggested the desirability of coordinating federal, state and local fiscal policy, but each of these studies has made the feasi-

[1] Papers and Proceedings, *American Economic Review*, XLVI (1956).

[2] The author is indebted to A. M. Sharp of the University of Cincinnati for the use of unpublished research materials on which much of this section of this paper is based.

[3] Alvin H. Hansen and H. S. Perloff, *State and Local Finances in the National Economy*, New York, 1944, p. 194.

[4] A. M. Sharp, *A Study of the Counter-cyclical Aspects of Total Government Fiscal Policy, 1929-1940*, 1956 (Unpublished doctoral dissertation in the Department of Economics, College of Commerce, Louisiana State University).

[5] Clarence Heer, "Stabilizing State and Local Finance," *Problems in Anti-Recession Policy*, New York, 1954, p. 134.

bility of such a program dependent upon a thoroughgoing rationalization of state and local fiscal structures.[6]

There are limitations to counter-cyclical policy at the state-local levels which are inherent in the nature of the services which state and local governments supply, the character of their tax revenue sources, and the market for credit which is available to them. Many institutional and political factors are involved. Most state and local expenditures cannot be subjected to the flexibility that counter-cyclical fiscal policy may dictate; for example, education, welfare, protection, and similar services do not depend on the ups and downs in business conditions, but rather on the number of people in the community and the quality of service desired. The tax and credit sources of state and local governments are even more inflexible than state and local expenditures. Unlike the federal government, these governmental units do not have the power to print money or the power to use, at their discretion, the credit of the Federal Reserve Banking System; therefore, state and local units cannot pursue deficit spending when and as desired. Also, state and local governmental units rely on tax sources, such as sales, excise, and property taxes, that are relatively insensitive to cyclical changes and have a relatively deflationary bias. Besides these limitations, probably the most serious obstacles to rational fiscal policies at the state-local levels are the institutional factors, such as statutory limitations of debts, uninformed political leaders, deep-seated traditional beliefs concerning the autonomy of the different levels of government, and intergovernmental competition for tax sources.

There is the further limitation that state and local fiscal action will have a relatively insignificant impact on the total flow of spending in the economy. Also, the fiscal policies of one state may have only a minimum influence on income and employment within its own boundaries. The economic effects of borrowing and spending by states will not be limited to their local economies.[7] The income generating effect of spending transcends state boundaries. Similarly, state borrowing typically takes place by the tapping of loanable funds both inside and outside the given state. To the extent the latter occurs, borrowing will have no restricting influence on local spending within the state. Clearly, the national and the local importance of fiscal policy at the state and local levels will depend, in part, upon the extent to which such action is concerted.

It is because of these limitations that Hansen and Perloff; Newcomer; Mitchell, Litterer and Dormar; Schere; White and White; and Blank have proposed basic changes in state and local fiscal structures.[8] All of these studies and the proposals arising out of them have much

[6] Hansen and Perloff, *State and Local Finance in the National Economy*, pp. 200-222; Mabel Newcomer, "State and Local Financing in Relation to Economic Fluctuations," *The National Tax Journal*, VII (1954), pp. 97-109; M. White and A. White, "The Impact of Economic Fluctuations," *The National Tax Journal*, VII (1954), pp. 17-29; G. W. Mitchell, O. F. Litterer, and E. D. Dormar, "State and Local Finance," *Public Finance and Full Employment, Postwar Economic Studies, No. 3*, Washington, 1945, pp. 122-130.

[7] B. U. Ratchford, *American State Debts*, Durham, North Carolina, 1941, pp. 547-549.

[8] Hansen and Perloff, *op. cit.*, pp. 200-222; pp. 243-283; Newcomer, *op. cit.*, p. 97-109; Mitchell, Litterer and Dormar, *op. cit.*, p. 126; L. Schere, "Tax Reserve for State and Local Governments," *National Tax Association Proceedings*, XXXVIII, 1945, pp. 187-199; M. White and A. White, *op. cit.*, pp. 17-39; and David M. Blank, "Reform of State-Local Fiscal Relations in New York," *The National Tax Journal*, III (1950), pp. 326-347; and IV (1951), pp. 79-91.

to recommend them. If there is a criticism, it is concerned with the impracticality of some of the proposals. The possibility that state and local tax structures can be basically altered is unlikely.

The resistance that may be encountered in changing state and local credit structures and the unlikelihood of establishing reserve or stabilization funds to facilitate controlled rates of expenditure do not, however, make impossible a coordinated federal, state and local fiscal program. Such a program would be feasible if a determined attempt were made to maintain or increase state and local capital expenditures during periods of depression. Federal support of state and local credit on an adequate scale would be a rational approach to the problem. One of the most encouraging signs that state and local capital expenditures may be maintained or increased in any future recession or depression is the decision of Congress to develop a National System of Interstate Highways. Recent legislation provides federal expenditures of $27.839 billion for highway purposes during the next thirteen years, with the actual expenditures to be made largely by state governments.[9]

Federal loans and grants to state and local governments for the purposes of education, highways and public welfare would seem to be the means by which a coordinated fiscal program may be possible. Federal loans and grants and state grants performed counter-cyclical roles in the '30s and have continued to grow in importance. One reason state and local governments should be placed in a position to make a positive contribution toward economic stability is that at the state and local levels traditional public services—highways, education, public welfare—are badly needed. A fiscal program coordinating state and local government action with federal government action should provide for social needs, as well as keep cyclical fluctuations within socially acceptable limits.

This writer has concluded elsewhere:

> If it should ever again become necessary for the federal government to make large expenditures for public works as a means of combating a major recession or threat of depression, it may well be that such action should be planned as a thoroughly integrated program to be conducted simultaneously at the federal, state and local levels of government. The major share of the operations of such a program might well be administered at the state and local levels. Such a procedure could be more efficient from an administrative standpoint and almost certainly would assure a more accurate job of matching expenditures with legitimate priority local needs. Counter-cyclical fiscal policy and efficient public administration need not be incompatible.[10]

The major responsibility for economic stabilization must lie at the federal level. However, the federal government, by operating through grants and loans, could ease the administrative burden at the federal level and effect concerted fiscal action at the state and local levels without altering state and local fiscal structures.

Elements of the New Economy

If economic stability in the economy is possible and a positive role may be played by state and local governments in maintaining this stability, is this the

[9] Federal Aid Highway Act of 1956, Public Law 627.

[10] William D. Ross, *Financing Highway Improvements in Louisiana*, Baton Rouge, Louisiana, 1955, p. 17.

major role that state and local fiscal policy may be expected to play in economic growth? What elements are there in the economy which will tend to assure economic growth if stability is maintained? Or, assuming economic stabilization, is there a more important role that state and local fiscal policy may play in stimulating or promoting economic growth? Answers to these questions involve an analysis of the role that state and local fiscal policy might play in a prosperous and stable economy to encourage economic growth on a local, regional and national basis.

Careful examination of the American economy at the moment reveals some rather startling transformations, changes which suggest the need for a still further re-evaluation of the fiscal policy aspects of state and local finance.

The foundation of fiscal policy, as the concept is understood by economists today and as the concept is used above, is Keynes' concept of the stable propensity to consume. Keynes states:

> The fundamental psychological law, upon which we are entitled to depend with great confidence both *a priori* from our knowledge of human nature and from the detailed facts of experience, is that men are disposed, as a rule and on the average, to increase their consumption as their income increases, but not by as much as the increase in their income.[11]

This psychological law in turn depends, according to Keynes, upon eight motives of a subjective character which lead individuals to refrain from spending out of their incomes:

> (i) To build up a reserve against unforeseen contingencies;
> (ii) To provide for an anticipated future relation between the income and the needs of the individual or his family, different from that which exists in the present, as, for example, in relation to old age, family education, or the maintenance of dependents;
> (iii) To enjoy interest and appreciation, *i.e.*, because a larger real consumption at a later date is preferred to a small immediate consumption;
> (iv) To enjoy a gradually increasing expenditure, since it gratifies a common instinct to look forward to a gradually improving standard of living rather than the contrary, even though the capacity for enjoyment may be diminishing;
> (v) To enjoy a sense of independence and the power to do things, though without a clear idea or definite intention of specific action;
> (vi) To secure a *masse de manaeuvre* to carry out speculative or business projects;
> (vii) To bequeath a fortune;
> (viii) To satisfy pure miserliness, *i.e.*, unreasonable but insistent inhibitions against acts of expenditure as such.
>
> These eight motives might be called the motives of Precaution, Foresight, Calculation, Improvement, Independence, Enterprise, Pride and Avarice; and we could also draw up a corresponding list of motives to consumption, such as Enjoyment, Shortsightedness, Generosity, Miscalculation, Ostentation and Extravagance.[12]

Keynes also notes that, apart from the savings accumulated by individuals, there is a large amount of income which is withheld by governments, by institutions and by business corporations for motives largely analogous to, but not identical with, those actuating individuals. These motives he lists, as follows:

> (i) The motive of enterprise—to secure resources to carry out further capital investment without incurring debt or raising further capital on the market;

[11] J. M. Keynes, *The General Theory of Employment Interest and Money*, New York, 1936, p. 96.

[12] *Ibid.*, pp. 107-108.

(ii) The motive of liquidity—to secure liquid resources to meet emergencies, difficulties and depressions;

(iii) The motive of improvement—to secure a gradually increasing income, which, incidentally, will protect the management from criticism, since increasing income due to accumulation is seldom distinguished from increasing income due to efficiency;

(iv) The motive of financial prudence and the anxiety to be " on the right side " by making a financial provision in excess of user and supplementary cost, so as to discharge debt and write off the cost of assets ahead of, rather than behind, the actual rate of wastage and obsolescence, the strength of this motive mainly depending on the quantity and character of the capital equipment and the rate of technical change.[13]

The accuracy of this analysis for the period beginning with the end of World War I and ending with the entrance of the United States into World War II, which is the period observed by J. M. Keynes and for which his analysis was intended, is not questioned. It is the suggestion of this paper, however, that it is an observable fact that the economic conditions, the cultural patterns, the social group relationships and the psychological attitudes that exist in this nation today are not the same that existed in the period observed and analyzed by J. M. Keynes. The psychological law has changed, and the implications of this change for fiscal policy are tremendous and far-reaching. In a paper of this sort, little more can be accomplished than to suggest the character of the change and to note some of its implications. Time and space will not permit the presentation of even such statistical data as may be marshalled in partial support of this somewhat iconoclastic proposition.

First, it is suggested that the cornerstone of existing fiscal policy theory, the stable propensity to consume, is no longer an accurate or applicable concept. Instead, the U. S. economy of 1956 is characterized by an *unstable propensity to consume* (in the upward direction). This, it is contended, is a fundamental and permanent change in the economic, social and cultural life of the nation. The change is the result of a fundamental transformation in the institutional and cultural structure of our society and of a general weakening or virtual elimination of some of the main motives which, as accurately analyzed by Keynes, led individuals to refrain from spending out of their incomes in the period between the two World Wars. The factors influencing the change are multiple, varied and complex. They include the welfare state philosophy of the New Deal, which was based in large part upon Keynesian fiscal policy concepts; the influence of the philosopher, John Dewey, upon education, psychology and social relationships in general in the United States; the unstabilizing and innovating influences of modern total warfare upon social and cultural patterns, as evidenced by increasing marriage rates, increasing birth rates, and the lower average age of marriage; and finally the application of modern promotional techniques through mass media of communication to the business of securing expansion and social acceptance of consumer credit.

Today, the typical American family proceeds without hesitation to mortgage its future for a period of twenty to thirty years for a new home; to purchase furniture, home appliances of all

[13] *Ibid.*, pp. 108-109.

types, and a new automobile on installment credit; and to have two to five children with little real concern for the educational and other advantages they may or may not be able to make available to their offspring. As soon as a portion of their mortgage and installment credit obligation is liquidated, they are ready for air conditioning units, boats, outboard motors and trailers, and back yard patios and swimming pools to go with their television sets, electric dishwashers and other modern luxuries. They are a ready market for new and better gadgets at all times. Their saving takes the form of accumulation of equity in homes and durable consumer goods resulting from mortgage and installment credit payments. Although there is still a great deal of public discussion of the problem of economic security for the individual family and there is even discussion of the problem within the family, the actions of the individual family belie this concern. The typical American family has become aware, although perhaps subconsciously, of the existence of a high degree of security in the U. S. economy today. This security is the product of public and institutional action, rather than individual action, but, nevertheless, it is real. Social Security provides minimum protection for the family in the event of the death of the breadwinner before the children in the family have reached maturity and minimum protection against the threat of becoming a charge upon family or community charity in old age. Group life insurance, retirement benefits, health and hospital insurance, free medical services, group saving plans, and a host of other fringe benefits provided by public and private employers add to the minimum security of the typical American family.

There is no need to build up the reserve against unforeseen contingencies, about which Keynes spoke; institutional bulwarks against such contingencies have been provided for the family. There is no need to provide for anticipated future income needs, such as those associated with old age, and, in the absence of this necessity, expanding current family incomes may be expected to coincide with needs for family education and the maintenance of dependents.

The desire to enjoy larger real consumption at a later date through smaller immediate consumption and the accumulation of interest and appreciation on current savings has been almost completely undermined by the spectacular postwar expansion in consumer and installment credit. The process has been reversed; the practice today is to enjoy the larger consumption now and do the saving later. In similar fashion, a desire for gradually increasing expenditures and improving standards of living still exists, but it no longer motivates saving in the conventional sense of the term. We employ credit to secure the higher standard of living now and do the saving later. We depend upon rising current incomes and an expanding abundance of new and improved products to give us continually rising expenditures and standards of living, rather than depending upon accumulation of savings from current income for increased future rates of expenditure.[14]

Conditioned by more than a decade of extreme economic insecurity during

[14] See Ruth P. Mack, "Trends in American Consumption and the Aspiration to Consume," Papers and Proceedings, *American Economic Review*, XLVI (1956), pp. 65-68.

the Great Depression, the desire for individual economic independence lost much of its influence in the American economy before World War II. A secure job with a depression-proof large corporate employer, *i.e.*, job security rather than individual financial independence, became the predominant motivation of the American family; this is still the case today despite the fact that the rationale of this motivation may no longer be applicable.

There has also been a transformation in the speculative or business motive. Individual accumulation and individual investment as the source of new equity capital has been largely replaced by institutional saving and institutional investment through insurance companies, trust funds, retained corporate earnings, etc. There remains the urge on the part of some to be able to bequeath a fortune to their heirs or to worthy causes of one type or another, but this motivation, too, for the typical family, has become far less important as prosperity has continued over a period sufficiently long that memory of the insecurity of depression has become a vague and unimportant influence, and as institutional assurances of broader educational and occupational opportunities for the children of today have been provided.

There are still some individuals who are motivated by what Keynes called "unreasonable but insistent inhibitions against acts of expenditure as such or pure miserliness," but there are almost no such individuals today under the age of forty, and the economic, social and political conditioning which the children and youth of today are receiving virtually assures the future elimination of such people and of such attitudes. Rising family incomes today call forth expenditures for better and bigger homes, automobiles and gadgets, rather than increased individual savings in past conventional forms. Not until amazingly high levels of family income are reached, in fact, do we find the conventional pattern of family saving occurring among the young people of the nation. Saving in the form of mortgage and installment credit repayments, through insurance programs, through retirement programs, and through other institutional actions is important and appears, with the assistance of newly created credit supplied by the vastly expanded and complicated money and credit system that has developed in this country, to have met demands for new funds in an expanding economy. Nevertheless, this type of saving and the motivations to this type of saving are far different from the motivations referred to by Keynes, and their influence upon the propensity to consume is entirely different.

War and postwar federal personal and corporate income tax laws, the progressive rate structure of these taxes, and the complex, discriminatory and capricious administration of these taxes have been another important influence in the transformation of the human motivations discussed above.

The importance, nature and motivations of governmental, institutional and corporate saving have also changed significantly, as suggested by the above discussion. The enterprise motivation to business accumulation is different for the farmer who produces his crops on governmentally guaranteed farm credit under governmental crop control regulations. The number of small businesses, proprietorships, partnerships, and small corporations, has not kept pace

with the increase in the population and the labor force so that these business savers are less important in the economy today than in the past. Professional managers of the nation's large corporations are not motivated in exactly the same fashion as the owner-managers of the past. Attitudes toward external debt and equity financing have been influenced by the tax structure and by the changing position of corporate managers. The liquidity motive has been subjected to statutory control not known in the past. Continued prosperity, new features of the economy believed to be permanent, and a gradually evolving long-term optimism for the future have greatly altered the liquidity motive. The improvement motive and the financial prudence motive, as described by Keynes, have also undergone considerable change in the past fifteen years.

These complex and varied changes that have occurred in the economy since 1940, and with accelerated rapidity and final fruition only within the past five years, would seem to supply the explanation of many recent economic phenomena. They would seem to explain decreasing ratios of savings of individuals in the conventional forms of bank savings accounts, savings and loan association share accounts, etc., and the significantly increased withdrawal or turnover rates of such conventional savings —the latter development indicating the short term nature of such savings which are associated in an ever larger number of cases with short term down payment accumulation for the purchase of major durable consumer goods items such as housing and automobiles. They explain the tremendous expansion that has occurred in institutional saving and investing, particularly through insurance companies and trust funds. Above all, they would seem to explain the phenomena of continued prosperity, full employment and expanding national production in this country, coincident with relatively stable rates of net private investment and of net governmental expenditure. There would seem to be only one explanation for this development; the propensity to consume in the American economy has become highly unstable. With each new year and each expansion in the gross national product, the propensity to consume is shifting upward. The very slope of the consumption expenditure curve in recent years gives some evidence of this development.

Is this a permanent change in the basic structure of the economy? There is every reason to believe that it is both basic and permanent.[15]

Implications for Fiscal Policy

What are the implications of this change for fiscal policy at the federal, state and local levels? First, it means the end of counter-cyclical fiscal policy in Keynesian or neo-Keynesian terms; it means the end of the budget-deficit–budget-surplus approach to fiscal policy. It means the end of the deflation-depression aspect of the economic stabilization problem. On the other hand, it signifies an increase in the magnitude of the inflation control problem. It adds a new and fundamental economic element which is predominantly inflationary, the unstable propensity to consume, to the predominantly inflationary socio-political element, the danger of

[15] It is obvious that the ramifications of this development, if this analysis is correct, are not limited to fiscal policy but will affect every aspect of the economic and social life of this nation.

monopoly impelled price-wage spirals, which Keynes had apparently come to fear before his death.

For tax policy at all levels of government, this analysis, if it is correct, would seem to suggest the more extensive use of consumption-repressive luxury excise taxes on commodities and services, as a means of controlling inflationary pressures and of assuring an adequate flow of resources into private investment in new plant and equipment and into public investment in essential public works and national defense.

If depression is no longer a threat, a much-needed rationalization of the federal income tax structure would also be feasible. It has been prohibited by concern both as to the influence of such a move upon effective demand and upon business incentives. Such action could add greater equity and integrity to the entire tax structure and improve its efficacy for inflation control. Many uneconomic tax-motivated distortions in the current operations of private business firms could, thereby, be eliminated, increasing significantly the efficiency of the entire economy.

On the expenditure side, it means an end to public works planning for purely counter-cyclical fiscal policy purposes. It means that public expenditures for public works and other purposes must be justified on their own merits. It means that the regular operating expenditures of government and public works expenditures by government must be measured by the criterion of their contribution to economic growth in the economy. It means that the financing and timing of such expenditures must be measured in terms of the inflation control criterion. Government functions and government expenditures, which are essential to economic expansion in the economy, such as highway improvements and expanded and improved schools, cannot be deferred to periods of deflation and recession, if no such periods are to reoccur; nor can such expenditures be deferred because they create inflationary pressure. To delay such necessary public improvements would create disastrous bottlenecks in the expansion of the entire economy and the standard of living of the nation.

For debt policy, this analysis suggests the use of governmental debt management as an antiinflation weapon. It suggests the possibility of gradually and permanently reducing governmental debts in the economy. This, however, is the long-term over-all implication. In cases involving the financing of major capital expenditures such as the construction of highways, bond financing may be the soundest approach that can be used. It will frequently be the only means of securing the needed improvements in a reasonable period of time and of facilitating the growth of our economy.[16]

Finally, this analysis suggests that there has developed in modern American capitalism a self-generated equilibrating mechanism which gives the system great economic stability, as well as the drive of harnessed individual human initiative. This has important implications for the role of government in this new and improved brand of capitalism, to which we have apparently fallen heir. A rational approach to the role of government in this new capitalism, of necessity, dictates that the role of government must be greater than the role

[16] William D. Ross, *Financing Highway Improvements in Louisiana*, p. 18.

allocated to government by classical economics, even though this, too, was economics of growth. Nevertheless, the *new economics of capitalism suggested in this paper* implies a limited and easily controlled role for government in the economic system, rather than the Leviathan of neo-Keynesian counter-cyclical fiscal policy economics.

Changes may be needed in the size of government at the various levels. There is much to be said for returning a larger share of the responsibility for government to state and local levels. These governments are more capable of assuming this responsibility than ever before. If the analysis of this paper is accurate and the danger of recession and depression is no longer a serious problem, the greater flexibility of fiscal action at the federal level is no longer necessary.[17]

Coordinated action at all levels of government will be essential, however, if government is to supply those services of government which are essential to economic growth at the appropriate time and in appropriate quantity and quality. Coordinated and well planned action will be equally essential if government is to succeed in controlling the very strong inflationary bias of this new economy. Many new policies and new practices will have to be adopted at all levels of government.

[17] William D. Ross, "Responsibility of the States for Highway Financing," *1955 Proceedings, National Tax Association*, Sacramento, California, 1956, pp. 60-69.

INVESTMENTS IN UNITED STATES GOVERNMENT SECURITIES BY STATE AND LOCAL GOVERNMENTS

COLIN D. CAMPBELL *

THE amount of U. S. Government securities owned by state and local governments has grown from $.4 billion in 1939 to $15.4 billion in 1955. Since the end of the Second World War, state and local governments have made net purchases of almost $9 billion in federal securities, and during the past four years they have made average annual net purchases of $1.4 billion. State and local governments are now important holders of U. S. Government debt. As shown in Table 1, in 1955 the amount of U. S. Government securities owned by state and local governments as a whole represented 7.5 per cent of the publicly held debt, that is, debt owned by others than Federal Reserve Banks and federal agencies and trust funds.

Because of the well known difficulties of state and local governments in raising the revenues needed to pay for their expanding public services, it is surprising that they have been able to invest large sums of money in U. S. Government securities. Questions arise as to the kinds of federal securities held and the types of state and local government funds being investing in these federal securities. Very little is known about the kinds of federal securities owned by state and local governments. Although monthly information is provided by the Treasury Survey of Ownership on the types of U. S. Government securities owned by federal agencies and trust funds, Federal Reserve Banks, commercial banks, mutual savings banks, life insurance companies, and fire, casualty and marine insurance companies, the survey does not include data on state and local governments. Some information on the composition of the holdings of federal securities by state and local governments is published in the annual reports of individual state treasurers. From such reports, it has been possible to get relatively complete data for 1954 on the holdings of 12 states.[1] In 1954, these states owned 28 per cent of the total amount of U. S. Government securities owned by all state governments. At the end of June 1954, state and local governments as a whole held $13.9 billion of U. S. Government securities; state gov-

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[1] Arkansas, Connecticut, Nevada, New Jersey, New Mexico, New York, North Carolina, Oregon, Rhode Island, Tennessee, Vermont, and West Virginia. The test of the completeness of the available information on each State's holdings was a comparison of these data with estimates published by the Bureau of the Census in its report on State Government Finances in 1954. These Census data are compiled by trained representatives from official records and reports of the various States. The total holdings of each of the 12 States as compiled and reported in this study are usually slightly smaller than the Census figure primarily because of the difficulty in getting information on holdings of all State agencies solely from published reports.

ernments held $9 billion; 482 cities with populations over 25,000, $2.7 billion; and the remaining local governments, $2.2 billion.[2] It is believed that the sample provided by the 12 states is adequate to support broad conclusions. The large amount of incomplete information on the 36 states not included and on local units is generally consistent with the data shown.

TABLE 1

U. S. Government Securities Owned by State and Local Governments, 1939–1955

End of Year	Holdings of State and Local Governments	Public Holdings *	State and Local Holdings as Percentage of Public Holdings
	(In billions)		
1939	$ .4	$ 38.6	1.0
1940	.5	41.1	1.2
1941	.7	52.5	1.3
1942	1.0	94.1	1.1
1943	2.1	141.7	1.5
1944	4.3	191.6	2.2
1945	6.5	227.4	2.9
1946	6.3	205.3	3.1
1947	7.3	200.0	3.7
1948	7.9	192.3	4.1
1949	8.1	198.9	4.1
1950	8.8	196.7	4.5
1951	9.6	193.4	5.0
1952	11.1	196.8	5.6
1953	12.7	201.0	6.3
1954	13.8	204.3	6.8
1955	15.4	204.3	7.5

Source: *Treasury Bulletin,* April 1956, p. 34.

* U. S. Government securities held outside Federal Reserve Banks and United States investment accounts.

Nature of Security Portfolios

In 1954 all 12 states studied invested heavily in U. S. Government securities, although the proportion of security holdings that were federal issues varied from 33 per cent in Tennessee to 96 per cent in West Virginia. Table 2 shows that the 12 states had $2.5 billion invested in Federal securities at the end of 1954. This represented nearly 65 per cent of their total portfolios. The remaining 35 per cent consisted of state and local government securities, corporate securities, mortgages, certificates of deposit, FHA debentures, nonguaranteed federal securities, and foreign government bonds.

TABLE 2

Types of Securities Owned by Twelve State Governments, End of Fiscal Year 1954

Type of Security	Amounts (In millions)	Per Cent of Total
All securities	$3,798.5	100.0
U. S. Government securities	2,457.4	64.7
State and local government securities	549.8	14.5
Corporate stocks and bonds	231.5	6.1
Mortgages	199.6	5.3
Certificates of deposit	155.5	4.1
FHA debentures and nonguaranteed U. S. securities	70.1	1.8
Not available *	134.5	3.5

* Includes primarily securities (probably mortgages and State and local government securities) for which separate data on types of investments other than U. S. Government securities are not available and some Canadian and International Bank bonds.

The investments of the 12 states varied widely in 1954. Even though most states held significant amounts of them, Connecticut did not own any state and local government securities. The bulk of the mortgages were owned by New York, and most of the time certificates of deposit were held by New York and North Carolina. Only four of the 12 states held substantial amounts of corporate securities. The

[2] *Treasury Bulletin,* April 1956, p. 34; U. S. Bureau of the Census, *Compendium of State Government Finances in 1954* (Washington, 1955), p. 45; and U. S. Bureau of the Census, *Compendium of City Government Finances in 1954* (Washington, 1955), p. 121.

laws of many states prohibit or severely restrict such investments. New Jersey is the only state in this group to invest heavily in nonguaranteed federal securities—particularly Federal Intermediate Credit Bank debentures and Federal Home Loan Bank notes. New Jersey also invested substantial amounts in discount notes of private corporations.

The 12 states held all types of U. S. Government securities — some nonmarketable securities and convertible bonds, as well as a large volume of marketable issues. The combined holdings of these 12 states in 1954 are shown, by type of security, in Table 3. The bulk of the $2.5 billion of U. S. Government securities owned by these 12 states in 1954 was either at the short or the long end of the maturity range. Table 3 shows that approximately 30 per cent of their holdings matured within one year; 10 per cent were intermediate-term issues that matured within from one to ten years; and 60 per cent represented various types of long-term bonds. The composition of the portfolios varied substantially, however, from state to state. All states owned long-term securities, but some states had practically no investments in short-term issues. Amounts of various issues held by each state are given in Table 4.

Major Classes of State Funds

Generally speaking, the kinds of securities owned by state governments depend on the types of funds they operate and reflect the needs of these funds for either short-term or long-term investments. Table 5 shows by type of state fund and principal types of U. S. Government securities owned by the 12 states. This table shows that the retirement systems and industrial accident and sickness systems invested primarily in long-term securities; that construction funds and Treasury balances were invested primarily in short-term securities; and that debt service retirement funds and permanent school funds were invested in both long-term and short-term issues.

Retirement systems. These funds held more federal securities than any other type of fund and accounted for approximately 37 per cent of such holdings by the 12 states.[3] All 12 states had one or more retirement systems with investments in federal debt. Most states administer several kinds of retirement systems covering such groups as teachers, state employees—frequently with separate systems for police, firemen, judges, hospital employees, or prison officers—and local government employees.

Industrial accident and sickness funds. The second largest investor was industrial accident and sickness funds. Included in this category are industrial commission funds, disability investment funds, segregated accident funds, disability insurance reserve funds, and workmen's compensation funds. Although only six states had funds of this type, their investments represented 21 per cent of the federal securities owned by the 12 states. The bulk of these investments was in New York.

Highway and construction funds. These funds include amounts held by

[3] In a special study by the U. S. Bureau of the Census for 1954—*Cash and Investments of Public Employee Retirement Funds in 1954* (Washington, October 14, 1955), p. 3—all State government pension funds combined were estimated to hold $2,938 million of U. S. Government securities, 32.6 per cent of the total of all such securities owned by the States.

turnpike authorities for construction and those held by the states for housing, airport, and other types of public construction. These funds are usually the proceeds of state bonds sold for construction purposes. Seven states had highway and construction funds, but the bulk of these investments was

TABLE 3

TYPES OF U. S. GOVERNMENT SECURITIES OWNED BY TWELVE STATE GOVERNMENTS, END OF FISCAL YEAR 1954

Type of Issue	Par Value (In millions)	Per Cent of Total
Marketable issues:		
Treasury bills	$ 429.9	17.5
Certificates	190.1	7.7
Treasury notes, by maturity	150.2	6.1
Within 1 year	95.1	3.9
1–5 years	55.1	2.2
Treasury bonds, by maturity	979.5	39.9
Within 1 year	19.6	.8
1–5 years	19.5	.8
5–10 years	165.4	6.7
After 10 years	775.1	31.5
Total marketable issues	1,749.7	71.2
Convertible bonds (Investment Series B)	573.5	23.3
Nonmarketable issues:		
Investment Series A bonds	13.5	.5
Treasury savings notes	7.6	.3
Savings bonds	113.1	4.6
Total nonmarketable issues	134.2	5.5
Total holdings	$2,457.4	100.0

held by New Jersey and Connecticut.

Debt service retirement funds. Nine states had debt service retirement funds. This category includes sinking funds and bond funds. These funds held approximately 11 per cent of the total amount of federal securities owned by the 12 states.

Treasury balances. The category "Treasury balances" includes general funds, inactive funds, temporary investments, tax stabilization reserve funds, treasurer's investments of fund balances, and general revenue investment accounts. Investments from these sources fluctuate seasonally. Although data on these fluctuations are not readily obtainable, it is believed that they vary considerably among the states since the amount invested at any given time depends on the dates when taxes come in or when large expenditures—particularly grants-in-aid to local governments—are made. Nine states had investments of this type. They amounted to 10 per cent of the total in 1954.

Permanent school funds. Although seven states had permanent school funds, these investments amounted to only 2 per cent of the total. Permanent school funds consist of receipts that are earmarked for educational purposes and are in excess of current needs. Such funds are usually obtained from the rent or sale of state owned lands.

Reasons for Rapid Expansion

The growth of state investments in U. S. Government securities has resulted primarily from the expansion in state welfare activities; however, all of the different types of state funds have probably expanded their holdings of federal securities during the past ten years. Although it has not been possible to get data for earlier years for five of the 12 states for which data were available in 1954, Table 6 compares the holdings of U. S. Government securities, by fund, for seven states in 1946, 1950 and 1954. Unfortunately several of the larger states had to be omitted from this comparison.

TABLE 4

INVESTMENT PORTFOLIOS OF TWELVE STATE GOVERNMENTS, END OF FISCAL YEAR 1954 *
TYPES OF SECURITIES HELD AND MATURITIES OF U. S. GOVERNMENT SECURITIES, BY STATES
(Par value, in thousands of dollars) †

Issue	Rate	Arkansas	Connecticut	Nevada	New Jersey ‡	New Mexico	New York	North Carolina	Oregon	Rhode Island	Tennessee	Vermont §	West Virginia	Total
Bills		.....	$145,178	.....	$151,482	$ 9,269	$ 44,356	$ 1,496	$ 20,000	$ 2,250	.....	$ 8,064	$ 47,761	$ 429,856
Certificates														
Aug. 15, 1954	2⅝	$ 2,318	.....	.....	.....	.....	.....	43,949	6,000	.....	.....	.....	500	52,767
Sept. 15, 1954	2⅝	.....	8,430	.....	.....	.....	.....	.....	22,450	1,500	.....	.....	1,000	33,380
Feb. 15, 1955	1⅝	7,263	.....	.....	5,000	.....	.....	.....	26,910	.....	.....	.....	.....	39,173
Mar. 22, 1955	1	.....	.....	.....	17,000	.....	.....	.....	.....	.....	.....	.....	.....	17,000
May 17, 1955	1⅛	894	.....	.....	43,190	.....	.....	.....	.....	500	.....	.....	200	44,784
Aug. 15, 1955	1⅛	.....	.....	.....	1,000	.....	.....	.....	.....	.....	.....	.....	.....	1,000
Dec. 15, 1955	1¼	.....	.....	.....	2,000	.....	.....	.....	.....	.....	.....	.....	.....	2,000
Notes														
Dec. 15, 1954	1⅞	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	5,600	5,600
Mar. 15, 1955	1½	.....	253	.....	43,500	.....	9,728	13,433	17,110	.....	.....	.....	5,500	89,524
Dec. 15, 1955	1¾	2,600	.....	300	.....	.....	.....	200	12,150	.....	.....	.....	1,345	16,595
Mar. 15, 1957	2⅞	.....	.....	.....	3,600	.....	.....	.....	61	4,000	.....	.....	.....	7,661
Feb. 15, 1959	1⅛	.....	.....	.....	265	.....	.....	25,265	2,370	.....	.....	.....	.....	27,900
Series EA & EO	1½	.....	.....	.....	2,900	.....	.....	.....	.....	.....	.....	.....	.....	2,900
Bonds														
Dec. 15, 1954	2	5,050	.....	238	31	.....	.....	7,406	3,000	3,800	.....	30	.....	19,555
Dec. 15, 1954–55	2	.....	.....	12	.....	.....	.....	.....	.....	.....	.....	.....	.....	12
Mar. 15, 1955–60	2⅞	.....	.....	263	14	.....	.....	.....	.....	.....	.....	.....	.....	277
Mar. 15, 1956–58	2½	.....	.....	250	2	.....	.....	.....	.....	230	.....	.....	.....	482
Sept. 15, 1956–59	2¾	.....	.....	175	.....	.....	.....	.....	.....	.....	.....	.....	.....	175
Sept. 15, 1956–59	2¼	.....	.....	.....	4	.....	.....	.....	.....	20	.....	25	.....	49
Mar. 15, 1957–59	2⅜	.....	.....	.....	.....	.....	.....	.....	.....	30	.....	.....	.....	30
June 15, 1958	2⅜	.....	.....	.....	5,350	.....	13,000	.....	.....	500	.....	5	.....	18,855
June 15, 1958–63	2¾	.....	.....	275	.....	.....	.....	.....	.....	.....	.....	.....	.....	275
Dec. 15, 1958	2½	.....	.....	.....	.....	.....	.....	.....	120	.....	.....	.....	.....	120
June 15, 1959–62	2¼	.....	.....	.....	21,173	.....	9,166	4,100	14,755	.....	.....	.....	1,000	50,194
Dec. 15, 1959–62	2¼	1,190	652	.....	74	.....	56,608	.....	10,463	3,405	.....	.....	2,765	75,157
Dec. 15, 1960–65	2¾	.....	.....	267	.....	.....	.....	.....	.....	90	.....	.....	.....	357
Sept. 15, 1961	2¾	.....	.....	.....	.....	.....	12,056	1,400	720	400	.....	.....	.....	14,576
Nov. 15, 1961	2½	.....	.....	.....	2,000	.....	2,000	1,000	2,060	1,630	.....	.....	43	8,733
June 15, 1962–67	2½	.....	500	100	16	.....	6,150	.....	2,500	2,217	.....	5	.....	11,488
Aug. 15, 1963	2½	.....	.....	.....	.....	.....	16,000	.....	.....	.....	.....	.....	.....	16,000

TABLE 4 (CONTINUED)

Issue	Rate	Arkansas	Connecticut	Nevada	New Jersey ‡	New Mexico	New York	North Carolina	Oregon	Rhode Island	Tennessee	Vermont §	West Virginia	Total
Bonds														
Dec. 15, 1963–68	2½	.....	655	500	6,805	.....	6,816	......	......	11,500	.....	100	3,800	30,176
June 15, 1964–69	2½	.....	4,470	1,980	5,429	2,436	40,554	9,040	500	.....	.....	175	9,240	73,824
Dec. 15, 1964–69	2½	450	2,675	.....	7,320	.....	67,582	1,840	1,000	100	$ 1,050	.....	8,690	90,707
Mar. 15, 1965–70	2½	.....	1,430	1,000	33,513	200	33,948	47,081	3,000	3,000	.....	120	24,422	147,714
Mar. 15, 1966–71	2½	.....	1,975	1,130	26,552	.....	25,908	3,000	......	60	.....	180	3,895	62,700
June 15, 1967–72	2½	.....	32	943	875	7,539	29,230	150	1,750	8,157	.....	.....	10,004	58,680
Sept. 15, 1967–72	2½	.....	......	.....	11	.....	45,029	21,450	......	97	.....	.....	......	66,587
Dec. 15, 1967–72	2½	635	7	.....	72,464	.....	33,892	5	4,750	2,025	100	.....	19,510	133,388
June 15, 1978–83	3¼	50	200	.....	76	3,123	66,810	18,018	330	1,200	3,850	55	5,762	99,474
Series B 1975–80	2¾	2,032	21,979	.....	51,237	.....	362,810	74,445	31,634	7,950	5,560	1,337	14,530	573,514
Series A 1965	2½	.....	250	.....	200	.....	10,795	650	790	.....	250	.....	545	13,480
Treasury savings notes	...	.....	......	.....	......	.....	......	......	......	.....	.....	.....	7,598	7,598
Savings bonds, Series F	2.53	.....	......	.....	1,084	.....	......	50	400	.....	.....	62	......	1,596
Series G	2.50	1,266	1,200	4,847	8,361	23,185	27,087	4,286	7,409	3,704	3,100	2,005	13,103	99,553
Series J	2.76	.....	......	.....	7	.....	......	......	......	.....	.....	.....	......	7
Series K	2.76	200	......	1,300	72	3,845	3,898	400	1,000	200	.....	100	883	11,898
Total U. S. Government securities		23,948	189,886	13,580	512,607	49,597	923,421	278,664	193,232	58,565	13,910	12,263	187,696	2,457,371
State and local government securities		16,522	......	10,809	92,114	38,559	295,416	36,550	26,242	2,556	22,292	223	8,540	549,823
Corporate stocks and bonds		.....	64,406	.....	153,805	.....	100	12	......	512	4,806	7,843	21	231,505
Mortgages		.....	......	.....	5	125	195,647	2,650	......	.....	.....	1,087	99	199,613
Certificates of deposit		.....	......	.....	......	.....	91,110	64,355	......	.....	.....	66	......	155,531
FHA debentures and non-guaranteed U. S. securities		.....	......	.....	62,988	.....	5,924	......	......	1,150	.....	.....	......	70,062
Other		.....	......	.....	......	.....	133,796	......	......	20	665	64	2	134,547
Total investments		$40,470	$254,292	$24,389	$821,519	$88,281	$1,645,414	$382,231	$219,474	$62,803	$41,673	$21,546	$196,358	$3,798,452

* The end of the fiscal year is June 30 except for New York State and the New Jersey Turnpike Authority and the Garden State Parkway in New Jersey. The Department of Taxation and Finance of the State of New York reported the securities administered by it as of December 31, and the Comptroller of the State of New York reported its holdings as of March 31, the end of the fiscal year for the State. The fiscal year for both the New Jersey Turnpike Authority and the Garden State Parkway ends December 31.

† Corporate stocks are listed at market value.

‡ Since $84,763,000 of U. S. Government securities held by the Garden State Parkway were unidentified, they were assumed to be distributed in the same way as holdings of the New Jersey Turnpike Authority's construction accounts: bills, $42,763,000; certificates, 5/17/55, 1½%, $24,500,000; notes, 3/15/55, 1½%, $17,500,000.

§ U. S. Government securities classified as "temporary investments," amounting to $8,064,000, were assumed to be invested in bills.

Sources: See p. 87.

Between 1945 and 1954 the type of welfare fund that has contributed the most to the continuous expansion in the holdings of federal securities by state and local governments has been the various retirement systems. These systems have had constantly increasing reserves to invest pending the anticipated growth in their benefit payments. Investments in federal securities by the retirement systems of the seven states included in Table 6 more than tripled in this period. Also, according to a study of pension funds by the Bureau of the Census in 1954, the assets of retirement systems of state and local governments increased a billion dollars between 1952 and 1953 and one and one-third billion dollars between 1953 and 1954.[4] These retirement systems have expanded rapidly despite the broadening of coverage of the Federal Old-Age and Survivors Insurance Program to include state and local government employees in 1950.

Table 6 shows a decline in holdings of U. S. Government securities by the highway and construction funds of the seven states from 1946 to 1950 and then a sharp increase from 1950 to 1954. When the Second World War ended, holdings of federal securities by "postwar construction funds" were large, but they tended to decline as opportunities to spend funds on capital construction opened up. The large increase in these investments from 1950 to 1954 shown in Table 6 resulted primarily from the purchase of almost $100 million U. S. Government securities by the highway fund of Connecticut. Investments of this type typically fluctuate sharply and will occasionally cause a state's total investments in federal securities to increase from 50 to 100 per cent within a year. A state's investments of this type are only temporary and will decline as the construction takes place.

Holdings of Treasury balances in federal securities in the seven states expanded from 1946 to 1950, but leveled off from 1950 to 1954. In states that have set up systems for investing their idle balances, such investments do not increase much from one year to the next; however, the investments by such funds in the states as a whole would expand as new states take advantage of earning interest income in this way.

The amount of federal securities owned by the other funds—industrial accident and sickness funds, debt service funds, and permanent school funds —have all expanded since the end of the Second World War, but have increased little in the past four years except for permanent school funds. Although most debt obligations issued by state and local governments today are serial bonds, some of the states have apparently established large reserve funds for these bonds.

Interest Income from U. S. Government Securities

The interest income received by the 12 state governments from their holdings of U. S. Government securities amounted to only a small proportion of their total revenues. Assuming that the securities listed in Table 4 were held for the entire year and the rate of return on bills was .94 per cent—the average for 1954—these payments amounted to $54.1 million in 1954, or 1.2 per cent of their total revenues. This interest revenue is, nevertheless, important to most state governments, and several of them have attempted to

[4] U. S. Bureau of the Census, *op. cit.*, p. 1.

maximize their income from this source. In 1950, New Jersey, for example, set up a Division of Investment to provide for centralized control of its investments, and they have attempted to maximize their interest income both by investing in long-term securities with higher yields and by investing any temporary surplus. Regarding the investment of their surplus, a former State Treasurer of New Jersey writes:

> This surplus arises out of the fact, for example, that our motor vehicle fees are collected in April and May and the State does not have use for them until November and the following February when substantial payments are made by the State for State aid for education and other similar disbursements. This program yielded to the State of New Jersey, $1,865,000, in the period April 1, 1951 to March 31, 1952. It is immediately self-evident that the safe, conservative investment of such moneys for short periods of time could return substantial sums in the way of interest earnings to the State of New Jersey thus making available for general State use moneys which otherwise simply did not exist.[5]

The State of New Jersey also invests the proceeds of bonds sold by the state for construction purposes in short-term securities pending the ultimate disbursement of the funds.

TABLE 5

TYPES OF U. S. GOVERNMENT SECURITIES OWNED BY MAJOR CLASSES OF FUNDS IN TWELVE STATES, END OF FISCAL YEAR 1954

Type of Fund	Total Holdings	Bills	Certificates	Notes	Treasury Bonds	Investment Series B Bonds	Nonmarketable Securities *
	Dollar Amounts (In millions)						
Retirement systems	$ 908.9	$ 3.0	...	$ 9.5	$415.1	$426.2	$ 54.9
Industrial accident and sickness	506.1	2.2	$ 2.3	5.0	341.0	131.0	24.7
Highway and construction	433.3	282.1	94.5	49.0	.1	7.6	...
Debt service retirement	257.7	51.8	16.1	15.3	158.9	...	15.7
Treasury balances	245.3	75.7	75.9	70.4	19.4	3.3	.5
Permanent school	43.0	9.3	...	...	14.9	1.3	17.6
Other †	63.0	5.9	1.3	1.0	30.1	4.1	20.8
All types	$2,457.4	$429.9	$190.1	$150.2	$979.5	$573.5	$134.2
	Percentage Distribution						
Retirement systems	100.0%	.3%	...	1.0%	45.7%	46.9%	6.0%
Industrial accident and sickness	100.0	.4	.4	1.0	67.4	25.9	4.9
Highway and construction	100.0	65.1	21.8	11.3	...	1.8	...
Debt service retirement	100.0	20.1	6.2	5.9	61.7	...	6.1
Treasury balances	100.0	30.9	30.9	28.7	7.9	1.3	.2
Permanent school	100.0	21.6	...	...	34.7	3.0	40.9
Other	100.0	9.4	2.1	1.6	47.8	6.5	33.0
All types	100.0%	17.5%	7.3%	6.1%	39.9%	23.3%	5.5%

* Includes savings bonds, investment Series A bonds, and Treasury savings notes.
† Includes New York's funds for insuring stock insurers, mutual insurers, and mutual carriers, trusts, endowments, and various insurance and reserve funds.

[5] W. T. Margetts, "Administration and Investment of Funds," *Municipal Finance*, Vol. XXV, No. 1, August 1952; p. 62.

New Jersey and some of the other states are apparently managing their cash balances in the same way as many business corporations. Nonfinancial corporations usually hold a large part of their liquid assets in short-term federal securities. In 1954 nonfinancial corporations as a whole owned approximately $19 billion U. S. Government securities. A study of the composition of the holdings of the 100 largest nonfinancial corporations in 1951 showed that the bulk of their holdings consisted of short-term issues.[6] These holdings of short-term federal debt by both nonfinancial corporations and state and local governments illustrate the widespread substitution of short-term U. S. Government securities for money as a store of value.

Only recently has legislation been passed enabling several of the states studied to invest their idle balances in short-term government securities.[7] Such laws were passed by Connecticut in 1949 and by New Jersey in 1950. In 1951 the auditors of Rhode Island's accounts recommended such a law, but the legislature has not yet acted upon the recommendation. Some of the other states included in this study—such as Arkansas, Oregon, and Vermont—have invested their idle balances in short-term federal securities during the entire postwar period. However, in 1954 some states—Tennessee, New Mexico, and Rhode Island—still kept their idle balances in demand deposits in banks and received no interest from these deposits. In New York, North Carolina, and Vermont, the government invests part of their idle balances in time certificates of deposit as well as in short-term federal securities. In North Carolina banks are legally required to pay a rate of interest on these deposits equal to that which the state could have earned by investing the funds in short-term U. S. Government securities.

[6] J. S. Sprowls, *Short Term Investment Practices of Large Non-Financial Corporations*, MBA Thesis (University of Pittsburgh, 1953), Table 2.

[7] See R. L. Funk, "Permissive Legislation Regarding Investment of Government Funds," *Municipal Finance*, Vol. XXV, No. 3, February 1953; pp. 111-119.

Conclusion

State and local government purchases of federal securities have resulted both from their expanding welfare and construction activities and from advantage being taken of earning interest on temporarily idle funds. Their purchases have helped to bolster the market for U. S. Government securities. The only other ownership groups whose investments in U. S. Government securities have continuously expanded since 1945 are federal agencies and trust funds and "miscellaneous investors"—consisting of savings and loan associations, nonprofit institutions, corporate pension trust funds, dealers and brokers, and

TABLE 6

AMOUNT OF U. S. GOVERNMENT SECURITIES OWNED BY SEVEN STATE GOVERNMENTS, BY TYPE OF FUND, END OF FISCAL YEARS 1946, 1950, AND 1954 *
(In millions of dollars)

Type of Fund	1946	1950	1954
Retirement systems ...	$ 28.6	$ 60.9	$102.0
Industrial accident and sickness funds	31.8	72.9	80.8
Highway and construction funds	28.2	11.7	138.5
Debt service retirement	27.5	58.5	56.0
Treasury balances	67.6	103.8	101.1
Permanent school funds	25.2	21.0	38.2
Other funds	9.5	15.3	24.7
All funds	$218.4	$343.9	$541.1

* Arkansas, Connecticut, Nevada, New Mexico, Oregon, Rhode Island, Vermont.

investments of foreign balances and international accounts in this country. Throughout the past ten years both insurance companies and mutual savings banks have obtained funds for loan expansion by selling federal securities to other ownership groups. In some years, commercial banks also have disposed of large quantities of federal debt. State and local governments have provided an expanding market for some of the federal securities sold by these groups.

TABLE 4 (Continued)

Sources:

Arkansas: *Biennial Report of the Treasurer of the State of Arkansas for the Biennial Period Beginning July 1, 1952, and Ending June 30, 1954,* Little Rock Arkansas, 1954.

Connecticut: *Report of the Treasurer for the Fiscal Year Ended June 30, 1954,* State of Connecticut Public Document No. 10, Hartford, Connecticut, 1954.

Nevada: *Report of the Treasurer of the State of Nevada for the Fiscal Year Ending June 30, 1954,* Carson City, Nevada, 1954.

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MANAGEMENT SURVEY OF THE OHIO DEPARTMENT OF TAXATION—A PROJECT OF SELF-SCRUTINY

ADDISON E. DEWEY *

OVER the years tax collectors have received little popular acclaim and much criticism for their efforts in the public's behalf. Much of the criticism undoubtedly has been rooted in people's seemingly instinctive and settled aversion to paying taxes. But quite apart from this, the criticism has emphasized the public's right to demand efficient standards of tax administration.

State tax departments are large enterprises which require internal efficiency if they are to administer tax laws effectively. In Ohio, for example, the Tax Commissioner administered or supervised taxes amounting to more than $613 million during the last fiscal year. The Department, not including the Board of Tax Appeals, has 878 employees, and a biennial appropriation from the General Assembly for the two-year period beginning July 1, 1955 well in excess of $9 million. This is a big, growing organization, and there is understandable concern within the state that the Department's efficiency keep pace with its size.

Because of the nature of their legal duties, tax administrators have often been so absorbed with audits and problems of taxpayer compliance that they have overlooked the need for continuing appraisal of their departments operations. Too often it has not been appreciated that departments of taxation consist of people who require guidance, stimulation, proper supervision, recognition of meritorious performance and so on, just as do employees in business organizations. Principles of good business management can and should be adapted to the affairs of state organizations. It was recognition of this fact which recently prompted tax officials in Ohio to undertake a full-fledged management survey of the Ohio Department of Taxation.[1]

In recent years business has been making more and more use of management consultants; as an indication the management consultant business is now said to gross more than $400 million annually. In Ohio's case, however, it was decided that the benefits which many companies have gained by having their methods and systems reviewed by outside consultants could be achieved in the Department of

* The author is Administrative Assistant to the Tax Commissioner of Ohio. This paper is based upon an address by the author to the 24th Annual Meeting of the National Association of Tax Administrators, Cleveland, Ohio, June 1, 1956.

1 The survey was instituted at the direction of Stanley J. Bowers, Ohio Tax Commissioner. The survey committee which conducted the study consisted of: James H. Maloon, Chief, Division of Research and Statistics; George S. Simpson, Chief, Division of Audit Review and Coordination; Addison E. Dewey, Administrative Assistant to the Tax Commissioner.

In passing, it may be noted that the state of Minnesota is currently conducting a self-survey of all departments of government.

Taxation through self-analysis. A survey committee was planned, therefore, which would include state officials with the varied backgrounds needed for such an undertaking: research, accounting, and law. It was also realized that the committee would need to bring a fresh viewpoint to its work, and therefore it was composed of people who had not been enmeshed in the day-to-day activities of various operating divisions of the Department.

The Tax Commissioner prepared the ground for the survey in a memorandum addressed to all division heads, section supervisors, district managers, and branch office managers. This memorandum emphasized the constructive spirit and purpose of the survey—that its objective was to improve the performance of the Department's administrative functions and achieve the best possible utilization of its personnel.

In approaching its analysis of the operations of various divisions the survey committee attempted to keep in mind certain fundamental principles. Sound tax administration includes a responsibility:

1. To enforce the tax laws fairly and uniformly in accordance with the statutes in order that all taxpayers will pay the full tax due. The honest taxpayer who complies with the law and pays the proper amount of his taxes is entitled to have the law applied uniformly so that his business competitors and others will also pay the proper taxes.
2. To make available to the taxpayer information which tells him how to comply with the law. Nothing is quite so frustrating as the situation where the taxpayer wants to comply with the law but is unable to for lack of information.
3. To draft tax returns, forms, rules and regulations in as concise and simple language as possible. It is recognized of course that tax statutes are necessarily complex in many instances, and therefore tax forms, rules and regulations probably can never be models of clarity.
4. To prevent, consistent with the demands of the law, the keeping of needless records by the taxpayers and the submission of information to the Tax Department that is not utilized in the administration of the tax laws.

A collateral purpose of the management survey was to obtain detailed information on the practical operation of the tax laws of Ohio—the manner in which and the extent to which such laws provide revenues for the support of the state and its political subdivisions. While the Tax Commissioner is authorized by statute to establish a division of research and statistics to study these aspects of the Ohio tax system, it was thought that an administrative survey of all the divisions of the Department would supply pertinent information concerning the adequacy of the entire tax structure.

Survey Method

The manner of proceeding with its investigation initially caused the committee some concern. It had been made clear that the group was to explore and analyze the functions of various divisions as fully as seemed desirable. This directive thus defined a prodigious job, and the committee therefore had to adopt some standards of procedure which would serve as guides for its activities. Complete candor forces me to confess that the committee, after considering many alternatives, discarded

any pretense of a rigorous, scientific approach to the problem and decided instead to begin with a down-to-earth, practical examination of a single division. The general approach used by the committee, with some variation, may be summarized as follows:

1) It was thought that a more comprehensive analysis of the operations of a division should be made if the committee first reviewed carefully the functions assigned to the division by law. In short, it was our purpose to determine what the law requires a given division to do in administering a specific tax law. To this end a careful review was made of each tax law and of those portions of the law in which the legislature had delegated administrative enforcement powers to the Tax Commissioner.

2) The next step was a thorough discussion with the division chief of the various operations of his organization. During these discussions, the members of the committee made it clear that the survey was to be conducted in a spirit of cooperation and that the chief should participate in the review of his agency's functions. It was also pointed out that the survey was not a fault-finding search but was rather a review of the division's adequacy to meet the demands imposed on it by the tax laws. The purpose of the survey was not only to ascertain the need to modify administrative procedures, where this might exist, but also to discover effective methods of administration being pursued by a division so that they might possibly be adapted to the operations of other divisions.

These discussions with division chiefs were valuable in giving the committee an over-all view of the many ramifications of the divisions' administrative operations. In those divisions that have now been surveyed, the division heads were most cooperative in discussing frankly with the committee members the administrative problems which they felt needed attention. They pointed out areas where they believed the administrative policy could be changed under existing law and others where legislation was needed to effect proper administration. The division chief was requested to give the committee a step-by-step description of the various operations of his division. In this way the committee members initially received a thorough understanding of the division's functions and became acquainted with each phase of the division's work flow—for example, the issuance of licenses or the receipt of tax returns, the processing of such returns, field audits, and the various other aspects of certifying taxes to the proper government officials for collection.

In addition to the various divisional functions, personnel problems were discussed with the division chief. Attention was given to the orientation and training of new employees, recruitment procedures, promotional policy, employee morale, territorial assignments to field examiners and their rotation, working conditions, the complicating factors connected with seasonal work loads, and other pertinent factors.

These discussions with the division chief served as a point of departure for the actual examination and observation of the division's operations; needless to say they furnished the background which made the detailed operations of the division understandable.

3) The attention of the survey committee was next directed to the office procedures of the division. Each phase of office procedure was reviewed with

the appropriate section head in considerable detail. Each step in the procedure was observed by the committee as it was handled by the appropriate employee. The detail of this phase of the committee's work may be illustrated by the investigation of certain divisions which handled excise taxes:

(a) The law provides for the issuance of licenses to engage in particular businesses. For these divisions the " work flow " began with the issue of such licenses.

(b) Consideration was next given to the receipt of tax returns and accompanying schedules by the division. The committee examined the office methods used in processing returns from the time they are initially received by the division, through an office audit, to the time when they are ultimately certified to the proper officer for collection. An important aspect of this review was a careful analysis of tax forms. Since tax returns are often the only means of contact between the taxpayer and the Department of Taxation, the committee scrutinized returns and forms to see if they clearly reflected the provisions of the tax laws and at the same time facilitated the taxpayers task of filling them out. More specifically, the committee sought to learn whether tax forms contained relevant material, whether they presented definitions and instructions which were adequate to permit taxpayers to comply with the law, whether they promoted uniformity, and finally whether they lent themselves to later processing and filing.

(c) The methods used in office audits of tax returns came in for close examination. While the office audit necessarily must consist largely of checking tax returns for arithmetical consistency, attention was also given to the checking of returns against information made available to the division by statutory devices. Areas of possible improvement through the use of mechanized equipment were likewise noted.

(d) A thorough analysis was made of procedures for refunding taxes where they have been overpaid. In this respect, attention was given not only to the audit methods used in verifying the accuracy of refund claims but also to the office operations used in rejecting or approving refund claims.

(e) The internal record-keeping methods of the division and the use of other sources of information to check the accuracy of returns were examined.

(f) An analysis was also made of the methods used in transmitting certain license fees and occasional funds resulting from tax findings to the proper government official. Specific attention was given to the proper keeping of records by the division to reflect the transmission of such funds to the State Treasurer.

4) The methods used in making field examinations of tax returns were personally observed by the committee in order to obtain insight into the field audit program. In this connection, committee members accompanied field examiners of the divisions through all phases of an audit of specific taxpayers. Attention was given to the use of audit forms on which audit data are compiled and findings submitted to the division headquarters.

5) Personnel of the division came in for considerable study by the committee. The committee was here concerned with full and appropriate use of personnel, employee morale, working conditions, equipment available to personnel, and the supervisory system of

the division. The instructions given to personnel by their supervisors were noted to see whether they were written and whether they clearly expressed divisional policies and what was expected of employees. Attention was also given to the management functions of the division chief and his supervisors —specifically, to such basic matters as the formulation of objectives, departmental organization, motivation of employees, the expression of divisional policy, and analysis of employee work performance. In order to gain more information on personnel matters, the committee on occasion interviewed various employees of a division to learn their views on the nature of their work, its relation to other functions of the division, and their attitude toward assigned work. It was found that most employees readily discussed their work, and on occasion, suggestions of considerable merit for the improvement of division functions were gained from such employee interviews.

6) Since each division surveyed is only a part of the whole Department, the committee inquired into each division's relations with other divisions. Consideration was given to the extent to which information is systematically exchanged among the divisions, since information is often obtained from an audit made by one division which properly could be used by a different division in the administration of another tax law. In a similar way a review was made of the division's relations with other governmental agencies with which the division should cooperate for efficient administration of the tax laws.

7) The many phases of the division's activities which might properly be called "taxpayer relations" were particularly noted. Attention to the clarity of instructions for completing tax returns and of the rules and regulations of the division which set forth its administrative responsibilities have already been noted. In addition, however, the committee examined the division's form letters and correspondence. It was thought that form letters and other correspondence which are courteous and clear and promptly dispatched may have a decidedly beneficial effect on taxpayer relations. Our system of taxation has been characterized as a "system of taxation by confession," and the importance of this aspect of a division's administration cannot be overemphasized.

8) The last phase of the survey was, of course, the preparation of a report to the Tax Commissioner on each division surveyed. Generally speaking these reports have dealt systematically with the subjects described in the preceding pages, concluding with the committee's major recommendations.

The objective of each report is to present a detailed statement of all phases of a division's operations. As submitted each report has been reviewed by the Tax Commissioner who has exercised his discretion in determining which recommendations of the committee would be put into effect. The implementation of these recommendations has been assigned to the division chief involved with the understanding that the Tax Commissioner would assign other personnel to assist the chief in appropriate situations.

Survey Progress Report

The effectiveness of this administrative survey, as with most management consulting surveys, is difficult to measure with precision. The survey deals largely with policy areas where tangible

results may not be readily perceived. In this type of undertaking it is quite easy to confuse activity with accomplishment, but it is the view here that this project of self-examination has been and will be a continuing force for the improvement of tax administration in Ohio. The project still has a long course to run since the committee has completed its survey of only two divisions. We believe, however, that the systematic analysis of the functions of these divisions has already justified the project. Further there is reason to believe that the beneficial effects of the project will be cumulative; when all divisions have been surveyed, factual data will be available which will enable us to view the many problems common to various divisions and departments in a larger and better perspective.

With no intention of being exhaustive, however, it may fairly be said that the administrative survey to date has accomplished the following:

1. It has produced a methodical analysis of the functions assigned by law to the divisions thus far surveyed. This review of legal functions has been salutary in that the exact scope of their legal duties has been reimpressed upon those charged with the responsibility of administering the law. Stated differently, an exploration of statutory duties has been a testing device for determining whether the division has complied with all of the relevant legal requirements.
2. The survey has produced an exhaustive examination of the administrative procedures in the division to determine whether procedures are justified by sound administrative policy or are merely the product of repetition and age.
3. An intangible factor of considerable significance is the desire for self-improvement which the survey is believed to have stirred up. It seems reasonable to assume that the process of self-analysis has preceded the committee in divisions which have not yet been surveyed. This factor of self-examination can have incalculable value, for it is the surest deterrent to people's tendency to slide into the "comfort of a routine."
4. An integral part of the survey has been the systematic collection of data concerning the operations of divisions, and their presentation in report form. The reports give the Tax Commissioner detailed information on sundry administrative processes of the divisions which he would not be likely to get in any other way. The reports which are also made available to the division chiefs involved, give the latter officials a refresher course on the detailed activities of their divisions. As noted it is hoped that the beneficial aspects of the study will be cumulative and that desirable procedures observed in one division may be adapted to the functions of an other division. Ultimately it is hoped that a survey of all divisions will furnish the Tax Commissioner with information to improve not only the functions of each division but also to effect changes which may appear desirable in department-wide administrative processes.
5. The survey has compelled a careful review of tax forms to determine their responsiveness to the tax laws, their clarity, and their elicitation of required information in an orderly manner. Similarly, a review has been made of departmental rules, regulations and other instructions which inform taxpayers of departmental policy and proper methods of compliance with the tax laws.

6. Perhaps one of the most notable results of the survey project has been the review of division operations by dispassionate officials who could approach problems with a fresh viewpoint. Many of the recommendations of the committee for modification of existing procedures can be attributed simply to its members ability to take a new look at the division's operations.
7. The administrative devices contained in the tax laws to aid effective administration were reviewed, and as a result it was found that in some instances these devices could be revitalized to furnish meaningful data to the division.
8. The rules of the Department were analyzed to see if they were in conformity with statutory provisions. Questions were raised as to whether certain rules could not be eliminated because they simply repeat the language of the statute. In other cases it was concluded that the promulgation of new rules would facilitate better administration.
9. The systematic gathering of information on divisional operations focused attention on the adequacy of the existing law with respect to administrative control devices. In this way the Tax Commissioner has been made aware of the need for legislative changes and can call these to the attention of the General Assembly.
10. Finally, the survey has developed the basis for better understanding and appreciation of the administrative problems of each division. In keeping with the constructive purpose of the survey, the committee carefully observed the administrative difficulties encountered by the divisions. Apprising the Tax Commissioner of the problems of the divisions has promoted better understanding of the intricacy of divisional operations.

While the project of self-analysis has focused attention on the need to revise some administrative practices, from an overall standpoint it has substantiated confidence in the various division chiefs to administer the tax laws assigned to them. Much that was commendable was found in the division surveys. Conscientious devotion to duty and assiduous attention to administrative detail constituted the usual rule. The cooperative attitude of the division chiefs and their personnel reflects a sincere desire by all concerned to improve the administrative processes wherever possible in the Department. The committee members were considerably impressed with the pride taken by the division heads and their employees in the complex task of tax administration.

Apart from tangible results of the administrative survey, there is also the important factor of self-satisfaction gained by all who are striving for a more effective performance of their duties. In these tax-conscious times it seems only fitting that tax laws should be uniformly and effectively administered. The honest taxpayer must be protected and administrative costs must be minimized consistent with proper administration. As the late Justice Holmes stated, " taxes are what we pay for civilized society."

NTA NOTES

GOLDEN ANNIVERSARY CONFERENCE

Columbus Ohio, October 21–25

Fifty years ago this fall, the National Tax Association held its first annual conference in Columbus, Ohio. On October 21 to 25, we will commemorate this occasion by holding our Fiftieth Annual Conference on Taxation in our birthplace. Every effort will be made to make this golden anniversary conference worthy of the traditions of the Association.

Stanley Bowers, dynamic Ohio Tax Commissioner, has accepted the chairmanship of the Program Committee. Suggestions for subjects and speakers will be gratefully received—particularly within the next few weeks while the program is in its formulative stages.

RONALD B. WELCH
Secretary

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The active National Tax Association committees and the chairman of each committee are listed below. Any member who desires information or wants to make suggestions to the various committees should feel at liberty to write directly to the chairman of the committee.

AUDITING COMMITTEE
Mr. W. Donald Jordan
Chemical Bank and Trust Company
165 Broadway
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BANK TAXATION COMMITTEE
Mr. Carter T. Louthan
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RESOLUTIONS COMMITTEE
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NOMINATING COMMITTEE
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EQUALIZATION STUDY COMMITTEE
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Ames, Iowa

MEMBERSHIP COMMITTEE
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College of Commerce and Business Administration
University of Illinois
Urbana, Illinois

INTERGOVERNMENTAL FISCAL RELATIONS COMMITTEE
Dr. Alfred G. Buehler
Professor of Public Finance
Wharton School of Finance
University of Pennsylvania
Philadelphia 4, Pennsylvania

1957 PROGRAM COMMITTEE
Mr. Stanley J. Bowers
Department of Taxation
State of Ohio
Columbus 15, Ohio

The following are two newly created committees for the benefit of the membership

HONORARY MEMBERSHIP COMMITTEE
Mr. E. M. Elkin
Westinghouse Electric Corporation
P. O. Box 2278
Pittsburgh 10, Pennsylvania

SERVICES TO THE MEMBERSHIP COMMITTEE
Mr. Anthony G. Quaremba
City Bank Farmers Trust Company
22 William Street
New York 15, N. Y.

J. L. Reuther
President

EDITOR'S NOTE

At a recent meeting of the Executive Committee of the National Tax Association, my request to be relieved of the position of editor was approved. Consequently, Professor Lawrence E. Thompson, who has served as either associate editor or acting editor since September 1951, has assumed the full editorship of the *Journal* effective with the publication of this issue. This appointment has been duly approved by the Executive Committee of the Association.

It is a pleasure to have the assurance that the *Journal* will be in the capable hands of Professor Thompson. He has had a large portion of the responsibility of editing the *Journal* during the last several years, and such success as the *Journal* has had can appropriately be credited in major degree to him. Professor Thompson has accepted the editorship with the understanding that the objectives and character of the *Journal* will remain the same as they have been since the *Journal* was first established under Professor Roy Blough's editorship in March 1948, and that the editor will continue to have the same degree of freedom in the management of the *Journal* as his predecessors have had.

At this time I wish to express my thanks for the cooperation which I have received from many persons while serving as editor of the *Journal*. The work of Professor Thompson and of Mrs. Eleanor Hodges and her predecessors as assistant to the editor has greatly lessened the burden on the editor. I am also most grateful to the many authors who have contributed articles to the *Journal* during the past six years and to those persons who submitted manuscripts which we were not able to publish. Finally, I should like to acknowledge the cooperation of the officers of the Association, the members of the Executive Committee, the members of the Editorial Advisory Board of the *Journal*, and to Messrs. Roy Blough and Richard Goode, my predecessors as editor. The constant availability of these individuals for advice and assistance has been of great help.

All manuscripts and communications for the editor henceforth should be addressed to Professor Thompson at Harvard University, Graduate School of Business Administration, Soldiers Field, Boston 63, Massachusetts.

J. Keith Butters

NATIONAL TAX ASSOCIATION

Organized 1907 — Incorporated 1930

OBJECT. The National Tax Association is a non-political, non-sectarian, and non-profit-making educational organization. Its object, as stated in its certificate of incorporation, is to educate and benefit its members and others by promoting the scientific study of taxation and public finance; by encouraging research; by collecting, preserving, and diffusing scientific information; by organizing conferences; by appointing committees for the investigation of special problems; by formulating and announcing, through the deliberately expressed opinion of its conferences, the best informed thought and ripest administrative experience available; and by promoting better understanding of the common interests of national, state, and local governments in the United States and elsewhere, in matters of taxation and public finance and interstate and international comity in taxation.

MEMBERSHIPS. The Association welcomes to its membership, for mutual discussion and deliberation, all who may be interested in taxation and public finance generally. Annual dues are: memberships for students in recognized institutions of higher learning, $10; memberships for government agencies, schools, and persons receiving more than one-half of their income from employment by such agencies or schools, $10; memberships for other individuals and unincorporated entities, $25; corporate memberships, $100; persons wishing to contribute more liberally to the support of the Association, $100 to $1000.

PUBLICATIONS. The NATIONAL TAX JOURNAL is published quarterly in March, June, September, and December. PROCEEDINGS of the annual conferences on taxation which are sponsored by the Association are published soon after the meetings. The JOURNAL and the PROCEEDINGS are sent to members without charge. To non-members the price of the JOURNAL is $5.00 per year, single numbers, $1.50. The prices of the PROCEEDINGS vary; that of the 1955 volume is $10.50.

Applications for membership, orders for publications, and general inquiries should be addressed to Ronald B. Welch, Secretary, National Tax Association, P.O. Box 1799, Sacramento 8, California.
